

DEFICIT AND DEBT IN TRANSITION



The Political Economy of Public Finances
in Central and Eastern Europe

Edited by István Benczes

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*The Political Economy
of Public Finances in Central
and Eastern Europe*

Edited by
ISTVÁN BENCZES



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István Benczes

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List of Abbreviations

AFD	Alliance of Free Democrats
CAEMC	Central African Economic and Monetary Community
CEE	Central and Eastern Europe
CEECs	Central and Eastern European Countries
CME	Coordinated Market Economies
CSO	Central Statistical Office
DBR	Doing Business Report
EBRD	European Bank for Reconstruction and Development
EFW	Economic Freedom of the World Index
EIU	Economist Intelligence Unit
EMU	Economic and Monetary Union
EU	European Union
EVS	European Values Study
FDI	Foreign Direct Investment
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
HDZ	Hrvatska Demokratska Zajednica (Croatian Democratic Union)
HI	Historical Institutionalism
HICP	Harmonized Index of Consumer Prices
HNB	Hungarian National Bank
HNB	Hrvatska Narodna Banka (Croatian National Bank)

HSP	Hungarian Socialist Party
HSWP	Hungarian Socialist and Workers' Party
ICTY	International Criminal Tribunal for the Former Yugoslavia
IDEA	International Institute for Democracy and Electoral Assistance
IEF	Index of Economic Freedom
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
LDS	Liberal Democracy of Slovenia
LME	Liberal Market Economies
MDS	Movement for a Democratic Slovakia
MFI	Monetary Financial Institutions
NATO	North Atlantic Treaty Organization
NEER	Nominal Effective Exchange Rate
NEM	New Economic Mechanism
OECD	Organisation for Economic Cooperation and Development
PE	Political Economy
PEP	Pre-Accession Economic Program
PLP	Polish Labour Party
PPP	Purchasing Power Parity
REER	Real Effective Exchange Rate
SDR	Special Drawing Rights
SEE	South Eastern Europe
SNP	Slovak Nationalist Party
Smer-SD	Smer-Sociálna Demokracia
ULC	Unit Labour Cost
UN ECE	United Nations Economic Commission for Europe
USD	US Dollar
VAT	Value Added Tax
VoC	Varieties of Capitalism
WAEMU	West African Economic and Monetary Union
WEF	World Economic Forum
WVS	World Values Survey
ZSSK	Železnická Spoločnosť Slovakia

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INTRODUCTION

Political Economy and Public Finances

István Benczes

“Very early in my graduate study, I was struck by the naiveté of the textbook commonplaces about political reality... It seemed self-evident to me that some model of politics is necessary before any analysis, positive or normative, of taxing and public spending could proceed.”

James Buchanan (2000:17)

“Most economists have now come to the realization that good economic advice requires an understanding of the political economy of the situation. The result has been a remarkable degree of collaboration between economists and political scientists, as well as more work on political economy by younger economists.”

Dani Rodrik (1996:38)

1 Institutions matter...

Even without a thorough knowledge of economics and/or political science, a slight sense of reality is just about enough to realise that any public decision is the result of a complex and often ambiguous process amongst a great number of players. Policy choice is, therefore, never simply a technical matter, but a matter of interest and political conflict. If this was not indeed so, then it would be hardly possible to explain why an exogenous shock can affect different countries differently; or why the *same* set of policies can have rather different effects from country to country. Consequently, the question that scholars sensitive to real-world phenomena should address is the following: “how political constraints may explain the choice of policies (and thus economic outcomes) that differ from optimal policies, and the outcomes those policies would imply” (Drazen 2000:6–7).

There seems to emerge an increasing consensus among researchers in both political science and economics that political institutions, mechanisms, and procedures can, indeed, add to the understanding of the great diversity in policy choice and economic performance across countries and period of times. Within this new consensus, the assumption of a social welfare planner seems to become totally obsolete. Instead, the general tendency for a *political bias* is underlined, which prevents the emergence of a socially desired optimum. Public policy is thus such that it necessarily “reflects the existence of distributional coalitions in society that seek to shape and control the allocation of public resources to the benefit of their members” (Grindle 1991:46). As a consequence, a politically rational public decision may not evidently be rational from an economic point of view. In consequence, in the real world, people have to live with second (or third) best policies instead of the optimal first best solution. According to Meier (1991:5), “[w]hereas the economist too often deals with the ‘first-best’ optimal policy, the government must live with the ‘second-best’ or ‘third-best’ in any hierarchy of policy choices.”

By now, it is common sense to claim that political and economic institutions can have a substantial effect on policy choices. As Bell (2002:363) has claimed, “[i]nstitutions are important, because, as entities, they form such a large part of the political landscape, and because modern governance largely occurs in and through institutions.” More importantly, institutions provide incentives and constraints, thereby structuring the activity of both political and economic actors (Steinmo 2001). That is, for contemporary social scientists, the question is not whether institutions matter or not but rather *which* institutions matter and *how* exactly they shape political and economic outcomes.¹ Even mainstream economics has managed to successfully integrate the study of institutions and has enriched the study of decisions on scarce resources with incredibly new insights—it is enough to mention here one of the most famous US-based think tanks, the National Bureau of Economic Research’s political economy group, which has explicitly recognized that “purely economic forces alone cannot explain complex phenomena such as different degrees of economic development, quality and types of economic policies, income distribution, and quality of government organization such as corruption,

¹ See, for instance, Pontusson (1995:118), who in his review argued that “the claim that institutions matter does not take us very far”; or Aspinwall and Schneider (2000:1), who claim that “[w]e are all institutionalists now.”

protection of property right etc. Political institutions are important determinants of these economic outcomes” (Alesina 2007: n.p.).

Although the study and analysis of institutions is quite popular, their consensual definition is still lacking. In one of his classic works, the Nobel-laurate economist, Douglass North (1990:4), defined institutions relatively loosely as “any form of constraint that human beings devise to shape action.” Later on, he added that institutions “are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behaviour, conventions, and self-imposed codes of conduct), and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies” (North 1994:2). Similarly, for political scientists, institutions are all “formal and informal procedures, routines, norms and conventions embedded in the organizational structure of the polity or the political economy” (Hall and Taylor 1996:938). Although institutions are often identified as constraints which structure social interactions, it does not necessarily imply that institutions reduce the scope and intensity of individuals’ actions; rather they can “open up [new] possibilities [...by] enable[ing] choices and actions that otherwise would not exist” (Hodgson 2006:2).

But if institutions are so important in a human’s life, why did it take such a long time for the academic profession to realize this? It is true that political economy has had a long tradition in the social sciences, dating back to at least the 18th century, but due to the rise and hegemony of (neoclassical) economics from the late 19th century onwards, the influence of political economy diminished. It managed to regain its former glory only as late as the 1980s—that is, ca. one hundred years after its almost total elimination. Its comeback is explained by the events of the late seventies, eighties, and early nineties. After experiencing two oil crises, the world faced an era of turbulent changes and transformations. The long economic stagnation and indebtedness of countries in Latin America, the disappointing, decades-long negative growth rates in Sub-Saharan Africa, the systemic change and the transformation process of Central and Eastern Europe, or the excessive spending and accumulated debt in so-called Western democracies turned the attention of the academia and the public to the positive and normative analysis of change and reform. Policy choice and reform have soon become solid and integrated parts of the scientific discourse.

All of these new experiences strived for (new) explanations, since the traditional, institution-blind analysis of mainstream economics or the behavioralist tradition in political science was not able to provide enough

food for thought. It became clear that the great diversity in economic performance required a better understanding of the polity and political institutions in particular, especially those which directly influence economic policies and economic outcomes. By giving up the oversimplifying assumption of a benevolent social planner, political economists offered more plausible explanations for phenomena such as poverty, growth, development, or even deficit bias. One of the greatest achievements of (the new) political economy has been that in its quest for explaining economic outcomes, it managed to endogenize (the process of) policy choice—formerly an exogenous factor in both neoclassical economics and in specific fields of mainstream economics such as public economics and public finance. As far as the latter is concerned (i.e., public finance), it was traditionally concerned only with “the analysis of the *effects* of alternative fiscal institutions on individual and group behavior in the private economy” (Sinn 2000:5–6; italics mine). In a democracy, however, an individual or group always has some capacity to “allocate his potential income between private uses and public or collective uses” (ibid.), that is, the given factors are themselves exposed to alteration. Political economy, therefore, aims at integrating the economic phenomena (the dependent variables) and the political-institutional phenomena (the independent variables) by assuming that political and economic constraints can largely determine economic outcomes. Consequently, in the revived study focus of political economy the “interest is in the *effect* of politics on economic outcomes, not on politics *per se*” Drazen (2000:9; italics as in the original).

By adopting such a perspective, it is not surprising that even if rational individuals would agree *ex ante* on a (cyclically adjusted) balanced budget as the optimal policy choice, the balanced budget position might not be the politically feasible equilibrium because of persistent distributional conflicts in the community. But if the informed audience understands why a balanced budget is not attainable *ex post* in a society where interest and preferences vary, the famous question of Bates—“Why should reasonable men adopt public policies that have harmful consequences for the societies they govern?” (Bates 1981:3)—cannot cause bewilderment any longer.

2 The political economy of public finances

From the early seventies onwards, the performance of public finances, measured mostly in public deficit and debt, started to reveal great diversity in the group of the most developed or so-called “industrialized” coun-

tries.² Some, like Belgium or Italy, faced an extraordinary increase in the stock of debt (to GDP): the two started in the late sixties with a ca. 50 percent debt-to-GDP ratio and within a decade each reached a level well above 100 percent. Other nations conducted a more disciplined fiscal policy and did not accumulate a debt stock higher than 50 percent even during and after the oil shocks.

The fact that these diverging patterns occurred within a small set of OECD countries is quite remarkable, as these countries—especially with regard to their economic activity and performance—are considered to be alike in several respects. But if they are truly similar, why can significant differences occur in their fiscal performance? Or as Alesina et al. have phrased it: “i) why do we observe large and persistent deficits in peace time and why now?; ii) why do we observe large debts in certain countries and not in others?” (Alesina and Perotti 1995:4). Additionally, if the deficit is huge and permanent, and it results in an explosion of the stock of the debt (in GDP): iii) why countries “do not stabilize [their public finances] immediately, once it becomes apparent that current policies are unsustainable and that a change in policy will have to be adopted eventually?” (Alesina and Drazen 1991:1170)

Unfortunately, standard economic theory is unable to provide convincing answers to these questions. Neoclassical theory argues that deficit and debt (increase) is the result of the temporary drop of output in recession or they are the consequences of the temporary increase of public spending due to wars, natural disasters, etc.³ Since a huge deficit and the accumulation of debt are temporary phenomena, they are eliminated in good times, when the general government automatically produces a surplus. In Keynesian macroeconomics, deficit and debt are also necessary and temporary by-products of the anti-cyclical stabilization measures of the government (and the working of automatic stabilizers), and are not considered as permanent phenomena.

Roubini and Sachs (1989) were amongst the very first who demonstrated that before the first oil crisis Barro’s neoclassical principle of tax-

² It was not always the case that governments produced deficit year by year, independently of the business cycles. Before the sixties, practically no written formula was needed in order to attain a balanced budget position (in normal times). Buchanan (1997) documented this brilliantly.

³ According to Barro (1979), a constant tax rate is always preferable to alternating tax rates in order to avoid tax distortions and deadweight losses. Thus, a temporary budget deficit and surplus is justified.

smoothing proved to be effectual. However, after the shock, an increasing number of countries allowed public spending to increase and deficit-financing became permanent, irrespective of the business cycles. The main point of the authors was that the economic policy responses of nations to the symmetric supply-side shock of 1973 were extremely diverse (or asymmetric). That is, it was not the shock itself which triggered the deterioration in fiscal performance and the degradation of fiscal discipline, but those domestic political-institutional factors through which the effects of the shock were asserted.

Political economy, therefore, turned its attention first to factors such as the electoral system, the party structure, the fragmentation of government, the political-social polarization and the structure of budget procedures (Alesina and Perotti 1995, 1996). More recently, however, political economy research does not take (political) institutions for granted; huge efforts have been dedicated to the understanding of the origin and change of institutions, too. Scholars in the new research program do not refrain anymore from engaging in the study of trust, culture, or identity. Besides formal institutions, informal ones such as norms, customs, or perceptions have also become widely acknowledged as part of political economy research (see Alesina 2007 or Guiso et al. 2009).

3 Why this book?

Political economy has managed to offer plausible explanations for the great divergence in the performance of public finances in the last 2–3 decades, including the dynamics of debt, and the persistency of deficit. The focus, however, has remained undeniably biased towards advanced countries and has neglected developing and/or transition economies. Although there have been publications on the public finances of Central and Eastern Europe (CEE; nowadays commonly referred to as “the new member states of the EU”), these seem to be reluctant to apply the conceptual and analytical framework of standard political economy to CEE countries because of the (implicit or explicit) assumption that CEE economies are *different* from their Western peers.⁴

⁴ The term “CEE countries” refers to Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

But is this really the case? Are CEE economies so much different that none of the well-known “Western” political economy concepts or models can be applied to the analysis of their fiscal performance? The major hypothesis of the present volume is that this is not the case. In order to justify the hypothesis, the volume applies a unique approach and structure. First, each chapter critically evaluates a widely accepted and used political economy concept or model, then the main findings of the specific model are confronted with the performance of CEE countries, either in a cross-country analysis (Part I) or in the form of a case study (Part II). Accordingly, one of the merits of this book is that it clearly demonstrates that models and concepts developed in “Western” academic circles can be safely applied in the context of CEE economies as well; that is, there is *no need* to develop a separate or unique theory designed for the study and understanding of (one-time) transition economies.⁵

Additionally, the applicability of widely acknowledged PE models and concepts to CEE countries makes it possible for the authors of this volume to verify that regional differences in the performance of public finances cannot be simply accounted for the inherited legacy of their communist past or a straightforward consequence of their transition process—or not in every case at least.

4 The structure of the book

Following the introductory chapter, Part I introduces four major political economy models and applies them in a comparative perspective by relying on cross-country analyses. In the opening chapter of Part I, Oliver Treidler provides a critical reflection on the current global economic and financial crisis by revealing a negative relationship between economic freedom on the one hand and public debt on the other. Treidler argues that incumbent policymakers have not been reluctant to respond to the current crisis by limiting economic freedom and expanding their own mandate. Such an approach, however, may end up in serious debt accumulation since—by and large—economic freedom and the level of public debt show a signifi-

⁵ Importantly, since the major goal of this book is to demonstrate that Western PE models and concepts are indeed able to explain the divergences in the performance of CEE countries, most of the studies are restricted in time and concentrate on the pre-global crisis period; that is, they focus on so-called “normal times.”

cant negative correlation. A better understanding of the nature of this relationship is vital for evaluating not just alternative policy choices but also the sustainability of public finances and the competitiveness of a country. Central and Eastern Europe has enjoyed a comparatively high degree of economic freedom. However, as the chapter demonstrates, the most recent developments do give cause for concern.

In Chapter 2, András Olivér Németh provides a critical evaluation of one of the most well-known models of PE, i.e., political business cycles. The chapter introduces the reader to both the theory of opportunistic political business cycles and partisan models. Whereas the former is dedicated to the study of the general incentives of governments in order to manipulate economic performance before elections, the latter is interested in capturing the likely differences between the political left and right and its consequences in terms of policy choice. Examining the fiscal performance of CEE countries, the chapter convincingly documents that both opportunistic political cycles and partisan differences prevailed in the region before the eruption of the current global crisis.

According to Alesina and Tabellini (1990), the persistent deficit and the consequent debt accumulation, which seemed to become a general tendency from the early seventies, cannot be explained by either myopia or political business cycles. Instead, incumbent politicians used both deficit and debt strategically in order to severely limit the new incoming coalition. Vera Takács and István Benczes apply this model with the aim of analyzing the debt dynamics of Central and Eastern European countries in order to reveal whether incumbents in the region behaved as it was predicted by the model. The authors claim that whereas public debt did serve the strategic aims of incumbents in Hungary and Poland, this was less straightforward in other cases.

In the closing study of Part I, Zsolt Szabó combines the literature on Varieties of Capitalism (VoC) with public finances in an original way and argues that while VoC has indeed devoted great efforts to the understanding of variety in Western capitalism, it has hardly done anything to broaden its horizon and incorporate either CEE or public finances. According to Szabó's findings, the two different paths of Western capitalist development, i.e., liberal market economies and coordinated market economies, are adequate to categorize the development of new EU member states; that is, there is no clear indication of any special Eastern European type of capitalism regarding the examined public finance issues.

The five chapters of Part II adopt a case study approach to the political economy of public finances, and their interest lies more rather

in informal institutions such as norms, trust, and culture, as opposed to formal ones. In Chapter 5, Gábor Kutasi documents that economic transformation of the Baltic countries was considered as a success for a long time—at least until 2007. These countries managed to maintain a sustainable and low public debt and high annual GDP growth rate. However, the external balance of the Baltics has shown an incredible deterioration at the same time. By applying the conceptual framework of Csaba (2008) and the saving-investment puzzle of Feldstein and Horioka (1980), the chapter argues that external imbalances were caused by and large by a so-called “passive macroeconomic populism,” which refers to an unlucky combination of steady and fast income growth and catch-up; and worsening external financing in terms of credits and loans taken out by households and the corporate sector.

Judit Kozenkow elaborates on the relationship between economic performance and institutions by applying the major concepts of new institutional economic theory. The chapter highlights the main characteristics of new institutionalism, provides a critical overview about its empirical literature, and applies its methods to analyze the determinants of the Polish economic performance between 1990 and 2010 with special attention to public finances and informal institutions. The chapter demonstrates why Poland was able to produce firm economic growth in spite of volatile budget deficits and increasing public debt. The author emphasizes the role of informal institutions and claims that strong informal institutions were able to support and complement formal institutions and even eliminate the counter-productive effects of weak fiscal performance in Poland.

Studying the communist and postcommunist development and public finances of Hungary, István Benczes demonstrates that budgetary overspending, huge internal and external debt, and stop-go policy cycles characterized both Hungary’s post-communist era (right from the beginning of the systemic change of 1989–90) and its socialist past—a phenomenon that was rather unique in the communist world. By applying an historical institutionalist perspective, the chapter argues that Hungary’s persistent budget deficit and the high level of public debt presents nothing new in the country’s history. A strong tendency for public deficit and debt, along with a hugely distorted structure of the general government, have been permanent features of the country for at least the past 50 years. The main hypothesis of the study is, therefore, that the reform success of the country in terms of marketization and liberalization dating back to 1968 and making Hungary the archetype of gradualist reform in the socialist bloc, came at the price of a premature welfare state which caused public

finances to deteriorate on a permanent basis—both in the communist and the post-communist era.

In Chapter 8, Dóra Gyórfy focuses on the influence of trust on the politics of structural reforms. It is argued that in an environment of distrust, institutions are unable to fulfill their function of guiding expectations and the time-horizon of individual plans is shortened. As vote-maximizing politicians cannot disregard the dominant time-horizon in society, public policy is also likely to be oriented on the short-term. In such an environment reforms become extremely difficult as long-term promises are not believed, while short-term costs are seen as losses rather than sacrifices for the future. The possibility for overcoming such impediments to reform are illustrated with the case of Slovakia, where a capable leadership took advantage of a window of opportunity presented by a crisis and started a virtuous cycle of successful policies and a lengthening time-horizon.

As Croatia has become the 28th member state of the European Union on 1 July 2013, it is a most welcome fact that the last chapter is dedicated to the study of Croatia and the role of Europeanization in its accession process and public finances. Fruzsina Sigér argues that contrary to the expectations, Croatia did not manage to join the EU together with other CEE countries in 2004 and 2007. It seems to have followed its own “non-mainstream” path, not only in Europeanization but also in several economic policy questions. The Croatian transformation and Europeanization process was interrupted by an armed conflict, which reshaped the priorities in the country and has had a long-lasting impact on the social, economic, and political dimensions of Croatia, including fiscal policy. The 1990s were characterized by war budgeting and a growth in the size of state. In the first decade of the 2000s the course of public finances changed, but consolidation steps were delayed. The financial crisis hit Croatia seriously, for the most part due to a persistence of deep structural problems. With the start of EU accession negotiations and the pre-accession surveillance procedure, more and more EU influence is visible and these processes serve as important anchors for structural reforms and fiscal consolidation in Croatia.

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CHAPTER 1

Economic Freedom and Public Debt in Central and Eastern Europe

Oliver Treidler

1 Introduction

In recent years, various researchers have analyzed the impact of public debt on economic growth. In a pioneering study Reinhart and Rogoff (2010) found that debt levels exceeding 90 percent of the GDP have a negative impact on growth. Subsequent studies have yielded similar results to those obtained by Reinhart and Rogoff. While the identified thresholds vary slightly, the main insight, namely, that a high level of public debt hurts growth, has been confirmed.¹ In the light of the current crisis, policymakers throughout Europe face numerous complex choices. Among the choices, those relating to public finances are arguably the most urgent. As public debt levels approach the critical threshold, policymakers are forced to put the sustainability of public finances on top of their agenda. The respective decisions will have a substantial effect on labor policy, taxation policy, as well as social policy. The bulk of alternative policy choices can be boiled down to choosing between greater or smaller economic freedom.

This chapter aims to illustrate that economic freedom and debt levels are negatively correlated. Economies characterized by a high degree of economic freedom tend to exhibit comparatively low debt levels. Understanding the nature of this relationship is crucial for evaluating the poten-

¹ The 90 percent threshold relates to mature economies. For emerging economies the threshold is lower (about 60 percent). A summary and review of respective studies is provided by Miller and Foster (2012). Caner et al. (2010) can also be recommended.

tial outcome of alternative policy choices. Extending the influence (or prerogative) of governments, even if intended to help overcome the crisis, may infringe the sustainability of public finances.

It is worth underlining, however, that it is beyond the scope of this chapter to propose specific policy prescriptions. The purpose is rather to demonstrate that economic freedom may serve as a sensible yardstick, which could provide much needed orientation to policymakers. The main argument is, therefore, that policymakers should carefully assess whether their policy choices threaten to curb economic freedom.

2 Theoretical background: Defining economic freedom

Providing a concise definition of a complex concept such as economic freedom is far from trivial. In the context of the 2012 Index of Economic Freedom (IEF), published by the Heritage Foundation, Miller and Kim (2012: 13–4) provide the following description:

Economic freedom is a condition [...] in which individuals can act with autonomy while in the pursuit of livelihood. Any discussion of economic freedom has at its heart [the] consideration of the relationship between individuals and governments [...] Economic freedom should encompass all liberties and rights of production, distribution, or consumption of goods and services. The highest form of economic freedom should provide an absolute right of property ownership; fully realized freedoms of movement for labor, capital, and goods; and an absolute absence of coercion or constraint of economic liberty beyond the extent necessary for citizens to protect and maintain liberty itself.

Economic freedom is closely entwined with concepts such as the rule of law or limited government and can be identified as a distinctly neoliberal concept. However, recognizing economic freedom as a neoliberal concept does not necessarily help in formulating a more precise definition. It is crucial to realize that among neoliberal scholars the discussion regarding an adequate relationship between individuals and governments has been notoriously fierce for decades.

Vanberg (2001) rightly characterizes the conflicts of opinion between Walter Eucken and Ludwig von Mises as symbolic and “repeatedly resurfacing.” These conflicts primarily revolved around different perspectives

on the nature or “organizing concept” of the liberal market order. For Mises, this was the concept of the “unhampered market”; whereas for Eucken, it was the concept of the market as a “constitutional order.” While Mises was heavily in favor of strictly limiting the role of government to that of a “night watchman,” Eucken envisioned the state to assume a more active role in providing an extensive institutional framework.

Besides Mises and Eucken, there have been many other influential thinkers on economic freedom. Wilhelm Röpke, for instance, who largely agreed with Eucken on many features of the desirable institutional framework, maintained that the state should additionally ensure social cohesion.² According to Kolev (2011), the position of Hayek was much closer to the position of Eucken than to the views of his own mentor Mises.³ Kolev further argues that when the neoliberal theory was imagined as a range spanning from Mises to Röpke, the theories of Hayek and Eucken may be regarded as constituting the “midpoint.”

Nevertheless, a clear delineation of the positions is not yet required at this point. It is sufficient to appreciate that the positions held by the proponents of neoliberal theory are highly heterogeneous. One must understand that it would not only be much too simplistic, but actually wrong to interpret a neoliberal concept such as economic freedom as implying an uncritical advocacy for following a *laissez-faire* approach. A range of theories spanning from Mises to Röpke is certainly compatible with multiple variants of capitalism.⁴ The vague definition of economic freedom thus reflects the heterogeneous nature of neoliberal theory. It is arguably best understood as constituting a basic common denominator, to which the aforementioned proponents could subscribe. The fact that Hayek, Mises, Eucken, and Röpke are founding members of the Mont Pelerin Society illustrates that they share a firm belief in the liberal paradigm, which Hayek (1944:21) described as follows:⁵ “that in the ordering of our

² To be sure, Röpke favored decentralized solutions (particularly strengthening the family), remaining deeply critical of a centrally organized welfare state.

³ A highly commendable comparative analysis of the works of Eucken, Hayek, Mises, and Röpke can be found in Kolev (2011). Kolev conclusively demonstrates that Hayek and Röpke may be regarded as *ordo-liberals*, opposed to Mises who remained fundamentally opposed to *ordo-liberalism*.

⁴ On Varieties of Capitalism, see Chapter 4 of this volume.

⁵ Complementary to Kolev (2011), it is highly recommended to read the comparative analysis of Klein (2004), which focuses on Hayek and Rothbard. Klein (2004:40) concludes that while the theories of Rothbard and Hayek cannot be reconciled word for word, they “can be blended into an overall interpretation of libertarianism.”

affairs we should make as much use as possible of the spontaneous forces of society, and resort as little as possible to coercion.” It appears sensible to assume that a wide range of liberal scholars, including Milton Friedman, Douglass North, and James Buchanan, would also readily subscribe to this common denominator.

The similarity between Hayek’s notion of the liberal paradigm and the description of economic freedom provided by Miller and Kim is obvious. Both clearly imply that the prerogative of government should be strictly limited. However, as elaborated above, this general notion is compatible with multiple variants of capitalism. Hence, applying economic freedom as a yardstick for policymakers does not imply that countries should strive to attain a sort of “maximal” economic freedom. Ultimately, the degree of economic freedom is to be understood as a choice which must match the respective preferences prevailing in a society.

2.1 Measuring economic freedom

The IEF utilizes a composite indicator to measure economic freedom. As a detailed explanation of the methodology is provided in the appendix of the IEF, only selected aspects will be reflected upon.⁶ In its handbook on constructing composite indicators, the OECD (2008:13) provides the following definition: “A composite indicator is formed when individual indicators are compiled into a single index on the basis of an underlying model. The composite indicator should ideally measure multidimensional concepts which cannot be captured by a single indicator, e.g. competitiveness.”

Economic freedom clearly constitutes a multidimensional concept. It also exhibits numerous overlaps with other multidimensional concepts, such as competitiveness or market integration. Unsurprisingly, many of the indicators applied by the IEF (and EFW) are also contained in other well-known composite indicators, such as the World Bank’s so-called Doing Business Report (DBR) and the Global Competitiveness Index (GCI) published by the World Economic Forum (2012). The data used by the IEF stems from organizations such as the IMF, the World Bank, and

⁶ The methodology applied by the Economic Freedom of the World Index (EFW) published by the Fraser Institute is very similar to that applied by the IEF. See Gwartney et al. (2011). The definition of economic freedom underlying the EFW can be considered to be identical to that of the IEF.

the Economist Intelligence Unit. In sum, the IEF can be considered to follow a rather orthodox approach, exhibiting no particular idiosyncrasies. As such, the methodology applied by the IEF may be assumed to enjoy a certain degree of political legitimacy.⁷

It is important to stress that the IEF, like all composite indicators, is subject to limitations and caveats. One of the most difficult aspects in constructing composite indicators is to determine adequate weights and aggregation methods. In some cases there may be sound arguments to allocate different weights to individual indicators, particularly when some indicators are assumed to be of higher relevance than others. However, as no objective criteria for allocating weights exist, respective discussions must remain futile.

According to the OECD (2008:33), “the absence of an ‘objective’ way to determine weights and aggregation methods does not necessarily lead to rejection of the validity of composite indicators, as long as the entire process is transparent.” Considering the detailed information available, the process adopted by the IEF can be regarded as highly transparent. In order to determine the validity of composite indicators, the OECD defines seven so-called “Quality Dimensions” (interpretability, coherence, availability of data, etc.). There is no indication that the quality (validity) of the IEF should be considered as being inferior to the aforementioned composite indicators.

While the methodology applied by the IEF may enjoy political legitimacy and comply with the quality criteria defined by the OECD, it is important not to succumb to a false sense of accuracy. The OECD rightly cautions that the big picture obtained by composite indicators “may invite users (especially policy-makers) to draw simplistic analytical or policy conclusions. In fact, composite indicators must be seen as a means of initiating discussion and stimulating public interest” (OECD 2008:13).

The IEF is composed of ten specific “components” of economic freedom. These components, which consist of multiple quantitative and qualitative indicators, are grouped into the following four key categories: 1) rule of law (property rights, freedom from corruption); 2) limited gov-

⁷ The LIME assessment framework, which was endorsed by the EPC and the European Commission in the context of the Lisbon Strategy, utilizes many indicators applied by the IEF (e.g., the DBR).

ernment (fiscal freedom, government spending);⁸ 3) regulatory efficiency (business freedom, labor freedom, monetary freedom); and 4) open markets (trade freedom, investment freedom, financial freedom). Each of the ten components is graded on a scale from 0 (lowest) to 100 (highest). The ten component scores are equally weighted and averaged to get an overall economic freedom score for each economy.⁹

The IEF reflects the multidimensional nature of economic freedom and is compatible with Hayek's notion of the liberal paradigm. In sum, the IEF yields a rather fine-grained big picture of the degree of economic freedom and constitutes a suitable basis for initiating discussion.

3 On the relationship between economic freedom and public debt

The relationship between economic freedom and public debt is complex. Miller and Kim (2012:45) provide the following rough characterization:

In theory, debt financing of public spending could make a positive contribution to productive investment and ultimately to economic growth. Debt could also be a mechanism for positive macroeconomic countercyclical interventions or even long-term growth policies [...]. On the other hand, high levels of public debt may have numerous negative impacts such as raising interest rates, crowding out private investment, and limiting the flexibility of government to respond to future [...] crises.

In other words, while increasing public spending will (per definition) diminish economic freedom, in the long term its impact on the public debt level depends on whether it contributes to productive investment. One crucial factor in determining the effect of expansionary fiscal policies is the

⁸ While the quality of the IEF can be generally assessed as positive, it is important to be aware of its methodological caveats. One case in point is the calculation of the government spending score. Here the IEF applies zero government spending as the benchmark. Countries whose spending exceeds 58 percent of the GDP receive a component score of zero. While there is no objective way to calibrate indicators, this particular calibration penalizes debt too harshly (taking into account the thresholds mentioned earlier).

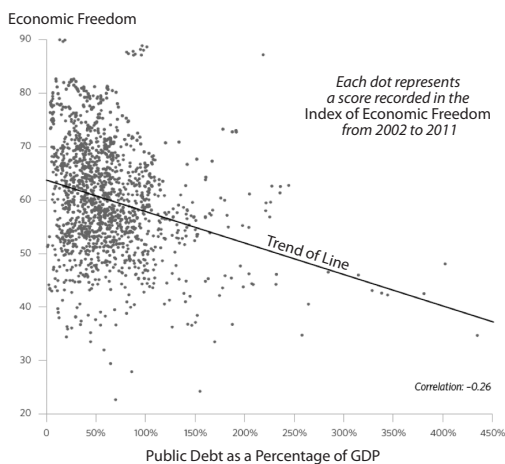
⁹ The EFW utilizes five key categories (which are almost identical to those of the IEF) and is composed of 42 indicators (or components).

composition of the expenditure. Benos (2009) found that expenditure on infrastructure and the enforcement of property rights tends to have a positive impact on growth, while expenditure on environmental protection or social protection tends to have negative effects.¹⁰

If expansionary fiscal policies fail to stimulate growth and tax revenues stagnate (or decline), debt will inevitably rise. In such circumstances, Miller and Kim (2012:47) argue that “[t]he permanent increase in the ratio of public debt to GDP [...] is prima facie evidence of policy failure. The high levels of public debt accrued in many countries thus reflect years of bad public financial management and the cumulative impact of poor policy choices. Such poor policy choices are highly likely to have restrained economic freedom as well.” Multiple components of the IEF capture the potential impact of public debt: monetary freedom (provides an explicit measure of inflation); government spending (score declines when expenditure is financed by debt); fiscal freedom (score declines when tax rates are increased to finance debt); and fiscal freedom (scores declines when public debt crowds out private sector access to credit and raises interest rates).

Figure 1.1, provided by Miller and Kim (2012), illustrates the relationship between economic freedom and debt. The figure shows a negative relationship between the accumulation of public debt and economic freedom.

Figure 1.1. Economic freedom and debt.



Source: Miller and Kim (2012).

¹⁰ Another factor to be considered is the fiscal multiplier, which in a crisis situation may be rather small or even negative—see Benczes (2008).

4 Public debt and economic freedom in Central and Eastern Europe: How economically free are the countries in CEE?

In the first step of the cross-country analysis, the *status quo* will be illustrated by providing a snapshot of the 2012 IEF. Table 1.1 contains the 2012 overall economic freedom scores and ranks, as well as the ten component scores, for CEE countries. In order to put the scores in perspective, Table 1.1 further contains the scores for the Netherlands, Belgium, Portugal, and Greece, as well as the regional (Europe)¹¹ and global averages.

Table 1.1. Economic freedom scores and rankings, 2012.

Country	Rank	Overall score	Property rights	Corruption	Fiscal	Gov. spending	Business	Labor	Monetary	Trade	Investment	Financial	Debt
Estonia	16	72.3	80.0	65.0	79.1	38.8	75.7	56.9	79.3	87.1	90.0	80.0	6.0
Lithuania	23	71.5	60.0	50.0	93.6	41.7	79.2	64.6	79.3	87.1	80.0	80.0	38.5
Czech Rep.	30	69.9	70.0	46.0	82.0	36.8	67.7	77.9	81.5	87.1	70.0	80.0	41.2
Hungary	49	67.1	70.0	47.0	78.6	24.0	79.8	67.6	76.1	87.1	70.0	70.0	80.6
Slovakia	51	67.0	50.0	43.0	84.2	48.2	71.0	58.1	83.5	87.1	75.0	70.0	43.3
Latvia	56	65.2	50.0	43.0	84.3	43.8	75.9	59.1	79.1	87.1	80.0	50.0	42.6
Bulgaria	61	64.7	30.0	36.0	93.6	50.3	72.7	84.2	77.8	87.1	55.0	60.0	16.3
Romania	62	64.4	40.0	37.0	87.4	55.1	70.5	62.6	74.3	87.1	80.0	50.0	33.3
Poland	64	64.2	60.0	53.0	74.4	40.3	61.4	61.3	79.1	87.1	65.0	60.0	56.3
Slovenia	69	62.9	60.0	64.0	64.8	27.9	81.4	42.2	81.2	87.1	70.0	50.0	47.6
Netherlands	15	73.3	90.0	88.0	51.2	20.9	81.9	60.0	83.6	87.1	90.0	80.0	65.2
Belgium	39	69.0	80.0	71.0	44.8	12.1	92.3	71.3	81.2	87.1	80.0	70.0	98.0
Portugal	68	63.0	70.0	60.0	59.0	25.5	83.0	32.5	82.6	87.1	70.0	60.0	107.8
Greece	119	55.4	50.0	35.0	65.3	16.2	76.3	36.6	72.6	82.1	60.0	60.0	165.3
Regional avg.	n.d.	66.1	61.3	55.5	72.4	35.5	77.5	61.4	78.3	85.5	69.9	63.7	82.5
Global avg.	n.d.	59.5	43.4	40.4	76.9	59.8	64.7	61.4	74.4	74.5	50.7	48.6	n.d.

Source: IEF (2012).

Note: The last column of the table shows the 2011 general government gross debt levels as percentage of the GDP (based on Eurostat); the regional average applies to the EU27.

¹¹ The region “Europe,” as defined by the IEF, includes 43 countries (the EU27 plus Switzerland, Russia, Turkey, and others).

Keeping in mind not to draw simplistic conclusions, the table still allows the formulation of some intriguing observations. At first glance the CEE countries enjoy a comparatively high degree of economic freedom, with all countries exhibiting significantly higher overall scores than the global average (179 countries are included in the 2012 IEF). Even measured against the tougher regional benchmark (Europe being the second most economic free region, trailing only North America), economic freedom in CEE countries has to be evaluated as positive. The bulk of CEE overall scores are concentrated around the regional average: the CEE average score is 66.9. Slovenia, exhibiting the lowest score among CEE countries (62.9 points), is arguably the only country that is significantly below the regional average. The scores of Estonia (72.3), Lithuania (71.5) and the Czech Republic (69.9) on the other hand are among the highest in the world. These general observations are strongly reinforced by the 2011 EFW. The IEF and the EFW exhibit a high rank correlation, but if anything the CEE countries rank even higher in the EFW (particularly Slovakia, Hungary, and Bulgaria, which are ranked 13th, 15th, and 28th respectively).¹²

By analyzing the component scores it is possible to observe characteristic strengths and weaknesses of the CEE region as well as of individual countries. The component “government spending” is, arguably, the most notable category. It is the only component in which the scores of all CEE countries are significantly below the global average. However, it must also be considered that compared to the regional benchmark CEE performs relatively strong, as only Hungary and Slovenia score below the regional average.¹³ The low scores mostly reflect the expenditure levels associated with European welfare states.

The component of “fiscal freedom,” measuring the tax burden imposed by government, is also highly intriguing. Aside from government spending, fiscal freedom is the only component in which the regional average for Europe is below the global average. In respect to the CEE region, it is noteworthy that only Slovenia scores below the regional average. Besides Slovenia, Poland is the only other CEE country not exceeding global average. Many CEE countries receive high scores for

¹² Based on the IEF and the EFW, a ranking of the ten CEE countries plus the four countries listed in Table 1.1 has been constructed. The Pearson’s correlation coefficient of the rankings is 0.705.

¹³ The methodology favors underdeveloped countries with little government capacity and hence results should be interpreted with care.

fiscal freedom, particularly Bulgaria and Lithuania, which are ranked 16th. Thus, compared to Western European countries such as Belgium, the Netherlands, and Portugal, the CEE countries have very competitive tax regimes translating to a comparatively high degree of fiscal freedom.¹⁴

In respect to the component labor freedom, the regional average equals the global average, reflecting the rigid labor market structures persisting in many European countries. Here, the scores of CEE countries are rather heterogeneous. Again, Slovenia exhibits the lowest score (barely above those of Greece and Portugal), ranking among the least free economies in this component (155th). Bulgaria, on the other hand, ranks among the freest economies (19th).

In respect to debt levels, the CEE countries differ markedly from other EU27 countries. With the exceptions of Hungary and Poland, no CEE country exhibits a debt level of above 50 percent. Considering that Hungary and Poland remain below the EU27 average (82.5 percent), the situation in the CEE region must be evaluated as being positive.

While detailed case studies are beyond the scope of this cross-country analysis, some observations may prove helpful for identifying worthwhile areas for further research. A very interesting potential case study appears to be Bulgaria. Ranked 61st overall by the IEF, the degree of economic freedom prevailing in Bulgaria is only slightly below the regional (and CEE) average. What sets Bulgaria apart from other CEE countries (except Romania), however, is that it exhibits high scores in some components (often the highest score among CEE countries), while receiving dismal scores in others. Aside from “investment freedom,” Bulgaria performs particularly poorly in “property rights” and “freedom from corruption.” The extent by which Bulgaria as well as Romania underperform relatively to their peers in respect to ensuring property rights and fighting corruption is also illustrated by the so-called “Worldwide Governance Indicators” (WGI) published by the World Bank. Of the fourteen countries shown in Table 1.1, Bulgaria and Romania receive by far the lowest WGI scores for corruption as well as for rule of law.¹⁵

¹⁴ Again, this is strongly reinforced by the EFW. Considering the sub-indicator “top marginal income tax rate,” Bulgaria, the Czech Republic, Lithuania, Romania, as well as Slovakia receive the highest possible score (10.00). Estonia and Latvia also receive very high scores (9.00) for this indicator.

¹⁵ The WGI utilizes a scoring scale ranging from -2.5 (lowest) to 2.5 (highest). Bulgaria is the only country receiving a negative score for rule of law (-0.09) in 2011. In respect to corruption, Romania (-0.20) actually receives a lower score

In a study that seeks to answer some questions that are similar to the ones addressed here, Muraközy (2010) further elaborates this aspect. Muraközy finds that, compared to Western European countries, many CEE countries perform weaker in the WGI than in the IEF or EFW. His explanation is that in the WGI the impact of informal institutions (customs, traditions, values, and unwritten rules) is stronger and that these in turn significantly impact the quality and efficiency of the formal institutions.¹⁶ From a political economy perspective it would appear sensible to prioritize on reforming the areas such as corruption as well as rule of law. However, the impact of informal institutions would have to be taken into consideration.

The economic freedom profiles of the other CEE countries are not as distinct as those of Bulgaria and Romania. However, taking the IEF and the EFW together it can be stated with a reasonable degree of confidence that Estonia and Lithuania are the economically most free among the CEE countries, while Slovenia and Poland are the least free.

Certainly, it would be feasible to discuss additional observations. However, keeping in mind the limited scope of this study, the most important observations may be summed up as follows. Overall, CEE countries enjoy a comparatively high degree of economic freedom. Compared to the regional benchmark, CEE countries exhibit a high degree of fiscal freedom. While CEE countries also outperform the regional benchmark in respect to government spending, they remain far below the global average and exhibit low scores. Compared to the EU27, CEE countries (except Hungary) exhibit low debt levels. Countries have specific economic freedom profiles. The component scores present a more fine-grained picture and may help to detect characteristic strengths and weaknesses.

than Bulgaria (-0.17). Greece (-0.15) is the only other country exhibiting a negative score. Among the remaining countries, Slovakia (+0.29) is the worst performing country, illustrating the extent of the gap. The WGI data is available at the World Bank-WGI homepage.

¹⁶ In a recent study Talmaciu (2012) presents similar arguments (focusing on explaining the poor institutional quality in Romania and Bulgaria).

5 How did economic freedom and debt evolve during the last decade? Is there a relationship with the evolution of competitiveness?

It is important to put the above snapshot into the historical context. By adopting a long-term perspective, the evolution of economic freedom can be assessed. In order to obtain as accurate a measure of the economic freedom as possible, the IEF and the EFW have been combined. As only the big picture is of interest here, only the overall scores are considered.¹⁷ In order to aggregate the two composite indicators, the EFW was multiplied by ten (equalizing the scoring scales) and the sum of the IEF and the (adjusted) EFW¹⁸ was divided by two (results in Table 1.2).

Table 1.2. Combined scores in a historical perspective.

Country	1995	2000	2002	2004	2006	2008	2010*	2012*
Estonia	61.10	71.75	76.30	76.55	76.50	76.70	74.70	72.30
Lithuania	50.35	62.35	66.90	69.60	71.35	70.85	70.30	71.50
Czech Rep.	62.85	66.80	66.55	67.75	66.65	68.4	69.80	69.90
Hungary	58.30	64.95	66.85	68.85	69.2	70.7	66.10	67.10
Slovakia	57.90	57.70	62.25	69.10	72.7	72.75	69.70	67.00
Latvia	53.45	64.80	67.60	68.15	69.5	68.55	66.20	65.20
Bulgaria	47.90	50.00	60.45	62.30	67.45	67.75	62.30	64.70
Romania	40.95	52.00	53.10	55.05	62.75	64.45	64.20	64.40

¹⁷ To be sure, analyzing the evolution of economic freedom on the basis of the component scores would allow for a more detailed assessment and is a worthwhile subject for future research. In this context, the study of Muraközy (2010) provides some noteworthy insights. He finds that after 2000, monetary freedom increased, while economic freedom in trade and business deteriorated. The analysis provided by Muraközy is primarily a case study of Hungary, rather than a cross-country analysis. However, those interested in the impact of informal institutions on the evolution of economic freedom may find some intriguing insights.

¹⁸ For the EFW the Chain-Linked Summary Index Ratings were utilized. As the 2011 EFW only provides scores for up to 2009, the overall scores for 2010 and 2012 shown in the table below are the IEF scores. For Bulgaria, Latvia, Lithuania, the Netherlands and Slovenia no 1995 data was available, 1996 data was used in lieu.

Country	1995	2000	2002	2004	2006	2008	2010*	2012*
Poland	51.60	60.95	64.00	62.90	63.65	64.55	63.20	64.20
Slovenia	49.00	60.95	61.25	62.35	63.4	62.70	64.70	62.90
Netherlands	73.85	75.45	76.45	75.70	75.20	75.95	75.00	73.30
Belgium	69.30	70.45	70.50	71.50	71.90	71.50	70.10	69.00
Portugal	67.80	69.60	69.75	69.85	67.25	67.30	64.40	63.00
Greece	61.50	63.80	62.85	63.90	64.60	64.40	62.70	55.40

Source: IEF (2012), EFW (2012).

Note: *forecasts.

Table 1.2 provides the following observations. First, one of the essential conclusions presented by Gwartney et al. (2011:15) in the context of the EFW can be confirmed, namely that “several economies that were centrally planned for many years have made remarkable progress during the past decade.” Assessing the evolution since 1990, Gwartney et al. (2011) identify Bulgaria, Romania, Poland, as well as Hungary as “big movers” (defined as countries having improved their summary ratings by between two and three points). In order to illustrate the magnitude of progress, it is worthwhile pointing out that globally only nine other (mostly African) countries are also classified as big movers.

Second, almost all CEE countries made tremendous progress between 1995 and 2000. Slovakia and Bulgaria are notable exceptions. However, between 2000 and 2006 Slovakia and Bulgaria substantially improved economic freedom, more than compensating for the lack of progress in the preceding period. Among the other CEE countries Romania, Lithuania, Estonia, Hungary, as well as Latvia continued to realize significant progress (at least four points). The Czech Republic, Poland, and Slovenia on the other hand more or less stagnated between 2000 and 2006.

Third, for the period between 2006 and 2012 economic freedom appears (on balance) to have stagnated in the entire CEE region. In some countries economic freedom has even declined since 2006; however, the magnitude of the regression is not very pronounced.

Fourth, compared to Western European countries the evolution of economic freedom within the CEE region must be seen as highly favorable. The data illustrates that economic freedom in the Western European countries has more or less been stagnant since 1995. For the period between 2006 and 2012 a negative trend can be observed, which is (slightly) more pronounced than for the CEE countries.

The major question is, however, how the evolution of economic freedom is reflected in terms of indebtedness and competitiveness (if at all). In view of the theoretical background presented above, it would be sensible to hypothesize that the significant improvement in economic freedom throughout the CEE region has been reflected in decreasing debt levels and improving competitive positions.

In the left hand columns of Table 1.3 the evolution of general government gross debt levels as percentage of the GDP (Eurostat) is summarized for the period 1995 to 2011. The columns on the right hand present two alternative measures of competitiveness. First, the GCI overall score for 2012–13 is shown (the scoring scale ranges from 7 [highest] to zero). The global rank (out of 144 countries) is shown in parentheses. In order to illustrate the recent development the difference between the 2012 and 2006 GCI score is shown in the adjacent column. The other measure of competitiveness is derived from an evaluation of the Lisbon Strategy¹⁹ presented in an earlier study (Treidler 2011). The column “2010” shows the score for the *level* of competitiveness achieved by 2010, while the column “2000–10” shows the score for the *progress* realized between 2000 and 2010. The scoring scale ranges from 5 [highest] to -5 (lowest).²⁰

¹⁹ The Lisbon Strategy was adopted by the European Council in March 2000 with the objective of turning the EU into the most competitive economy in the world. It constituted the blueprint for European economic policymaking in the period 2000 to 2010.

²⁰ The respective calculations are based on the “Lisbon key-indicators” (Eurostat). Compared to the GCI, which is largely based on survey data (the so-called “Executive Opinion Survey”), the evaluation of the Lisbon Strategy is predominately based on quantitative indicators. It is worthwhile to point out that the operationalization of the concept of competitiveness differs. While the GCI does not include “environmental sustainability” and “social cohesion,” these dimensions are included in the evaluation of the Lisbon Strategy. In my study, I present an overview of the evaluations of the Lisbon Strategy conducted by the ECB, the Centre for European Reform, as well as the World Economic Forum (which altered the GCI in order to apply it to the Lisbon Strategy). Unfortunately, Bulgaria and Romania were not included in the analysis. For details please refer to Treidler (2011).

Table 1.3. Debt and competitiveness.

Country	Debt					GCI		Lisbon Strategy	
	1995	2000	2004	2008	2011	2012*	2006–12	2010	2000–10
Estonia	8.2	5.1	5.0	4.5	6.0	4.64 (34)	-0.18	-0.89	2.42
Lithuania	11.5	23.6	19.3	15.5	38.5	4.41 (45)	-0.08	-1.97	1.41
Czech Rep.	14.0	17.8	28.9	28.7	41.2	4.51 (39)	-0.16	-1.85	-0.13
Hungary	85.6	56.1	59.5	73.0	80.6	4.30 (60)	-0.19	-3.39	0.23
Slovakia	22.1	50.3	41.5	27.9	43.3	4.14 (71)	-1.40	-2.22	1.19
Latvia	15.1	12.4	15.0	19.8	42.6	4.35 (55)	-0.12	-1.79	1.47
Bulgaria	108.3	72.5	37.0	13.7	16.3	4.27 (62)	0.29	n.d.	n.d.
Romania	6.6	22.5	18.7	13.4	33.3	4.07 (78)	0.09	n.d.	n.d.
Poland	49.0	36.8	45.7	47.1	56.3	4.46 (41)	0.07	-3.23	0.01
Slovenia	18.6	26.3	27.3	21.9	47.6	4.34 (56)	-0.14	-0.53	1.52
Netherlands	76.1	53.8	52.4	58.5	65.2	5.50 (5)	0.13	1.54	0.00
Belgium	130.2	107.8	94.0	89.3	98.0	5.21 (17)	0.15	-0.85	-0.67
Portugal	59.2	50.4	61.9	71.6	107.8	4.40 (49)	-0.07	-1.85	0.10
Greece	97.0	103.4	98.6	113.0	165.3	3.86 (96)	-0.26	-3.50	-0.16
EU 27	n.d.	61.9	62.3	62.5	82.5	n.d.	n.d.	n.d.	n.d.

Source: Eurostat, CGI, and Treidler (2011).

*Note: *rankings in brackets.*

Based on Table 1.3, the following observations can be stated with a reasonable degree of confidence. First, between 1995 and 2000 CEE countries exhibiting low levels of debt (below 30 percent) managed to sustain these levels. Bulgaria, Hungary and Poland, which faced markedly higher levels of debt in 1995, succeeded in reducing their debt levels. Considering that Slovakia is the only country not fitting into this pattern, it may be argued that the tremendous progress in respect of enhancing economic freedom is mirrored by a positive evolution in respect to public debt levels. Between 2000 and 2008 the evolution of public debt can also be regarded as positive (similar to that of economic freedom). With the exception of Hungary, the CEE countries generally managed to sustain low debt levels. There is, however, no clear relation to the evolution of economic freedom. Between 2008 and 2011 the debt levels exhibit a distinctly negative trend, mirroring the stagnation (slight regression) observed for economic freedom.

Second, the evolution of debt levels in the Western European countries is clearly not as positive. The Netherlands and Belgium, enjoying comparatively high degrees of economic freedom between 1995 and 2008, were successful in maintaining moderate levels of debt (the Netherlands) or achieving a significant reduction of debt (Belgium). Greece and (to a lesser extent) Portugal failed to reduce their comparatively high levels of debt, mirroring their persistently low degree of economic freedom. The negative trend in debt levels to be observed post-2008 is much more pronounced than in the CEE region, again analogous to economic freedom.

Third, with regard to the current level of competitiveness, the CEE countries still face a considerable gap compared to the more competitive Western European countries such as the Netherlands and Belgium. While all CEE countries (except Slovenia) have surpassed Portugal regarding economic freedom, only Estonia exhibits markedly higher scores than Portugal for both measures of competitiveness.²¹ Greece exhibits dismal competitiveness, matching the decline in economic freedom.

Fourth, the evolution of competitiveness is difficult to interpret. For the period 2006–12, the GCI shows a negative trend, with only Poland, Romania and Bulgaria improving their competitive positions. While Portugal and Greece also exhibit a deterioration of competitiveness, the Netherlands and Belgium realized sound improvements, thus widening the gap even further. However, looking at the longer term (Lisbon Strategy), most CEE countries achieved substantial improvements in their competitive positions. In fact Estonia, Latvia, Lithuania, Slovenia, as well as Slovakia can be identified as “big movers.” Hungary, Poland, and particularly the Czech Republic failed to substantially improve their competitive positions, similarly to Portugal and Greece. The Netherlands remained among the most competitive countries in the world, while Belgium faced a decline in competitiveness and was eclipsed by the most competitive CEE countries.

6 Concluding remarks

The first part of this article demonstrated that a negative relationship between the accumulation of public debt and economic freedom exists.

²¹ On the other hand, only Hungary and Slovakia exhibit lower scores for both measures. For the remaining countries, the level of competitiveness can be assumed to be on par with that of Portugal.

The cross-country survey conducted in the second part has by and large confirmed that relationship for the CEE region. For some periods the relationship was rather weak and the applied methodology was arguably rather crude; thus, the results must be interpreted with caution.

The CEE region enjoys a comparatively high degree of economic freedom. Estonia, Lithuania, and the Czech Republic are among the most free economies in the world and only Slovenia is somewhat below the regional (but still above the global) average. Since 1995, many CEE countries have realized tremendous progress and were consequently identified as “big movers.” This progress is mirrored by a positive evolution in respect to public debt levels.

However, while the overall picture is decidedly favorable, there is no room for complacency. Since 2008 the debt levels exhibit a negative trend, mirroring the recent stagnation (slight regression) of economic freedom. For policymakers, this trend should be somewhat worrisome. To be sure, public debt levels remain comparatively low, but should economic freedom continue to regress, the sustainability of public finance could weaken. As pointed out by Miller and Foster (2012:52): “Where economic freedom is high, debt may be sustainable even at higher levels. Where economic freedom is low, the impact of even moderate levels of debt is likely to be negative.”²²

Considering competitiveness a similar conclusion can be drawn; there is no room for complacency. While there are arguably some “big movers” in terms of enhancing competitiveness, on balance the progress was not sufficient to close the (still considerable) gap to the most competitive Western European economies.

In sum, there are sound arguments for utilizing economic freedom as a yardstick when making policy choices. Policymakers should carefully assess whether their policy choices threaten to curb economic freedom and be aware of the negative consequences. Various policies appear suitable to improve competitiveness as well as economic freedom, notably, improving the flexibility of labor markets and fighting corruption. However, it has been demonstrated above that countries have specific economic freedom profiles. Thus, one-size-fits-all types of policy recommendations do not constitute a promising approach. The neglect to account for country-spe-

²² Additionally, Reinhart and Rogoff (2009) point out that countries exhibit differing debt intolerance levels (depending on very long-term repayment and inflation history). The differing debt intolerance levels imply different thresholds for the sustainability of debt (here some CEE countries may be affected).

cific circumstances must be seen as an important reason for the failure of the Lisbon Strategy.

From a liberal perspective, it is important that the principle of subsidiarity will be strengthened within the EU. The Lisbon Strategy and its successor strategy (Europe 2020), by extending the prerogative of the European Commission, unfortunately constitute steps towards more centralization. Instead of relying on coercive means to harmonize European economies, it is preferable to remember the official motto of the EU (“united in diversity”) and engage in intergovernmental competition.

There is no optimal degree of economic freedom. The degree of economic freedom prevailing within a country ultimately must be understood as choice. This choice must be made in accordance with the preferences held by the citizens. Just as different variants of capitalism exist, mirroring differing preferences, the preferred degree of economic freedom will differ across countries. Observing the principle of subsidiarity will ensure that the degree of economic freedom matches the preferences of the citizens.

Disregarding the differing preferences and trying to enforce a specific variant of capitalism and a corresponding degree of economic freedom upon all Europeans constitutes a serious threat to further European integration (however well intentioned). As early as 1958, Ludwig Erhard (1958:213–4), similar to Röpke and Hayek, warned against excessive harmonization:

I do not exaggerate when I report that wages, pensions, holidays and overtime payments are considered in this context. If one is prepared to acknowledge the thesis of harmonization then there are no logical limits, and demands for taking into account the costs of electricity and transport or taxes can be made with the same justification. If an attempt were to be made to harmonize all costs relating to the position of companies from country to country and over a larger group of countries—that is, to balance them so that competition would cease to be “disturbing”—then this does not mean integration but disintegration of the worst kind.

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CHAPTER 2

Political Business Cycles: Theory and Empirical Findings for the CEE Region

András Olivér Németh

1 Introduction

By choosing the appropriate tools of economic policy, governments are able to influence economic performance. They can also use this to increase their chances to remain in power. The theory of political business cycles aims to investigate the motives and behavior of politicians and analyze how elections appear in the business cycle. The term “business cycle” originated from Kalecki (1943); however, its meaning has changed since then to some degree, and as economic theory developed, newer and newer models have appeared to explain this phenomenon.

The first section of this chapter describes the most important theoretical models of political business cycles. The chapter also elaborates on some empirical findings of the literature and observes how the maturity of democracy relates to the appearance of the cycles. This is a significant factor, because according to this theory, with time, the new democracies of Central and Eastern Europe may overcome this lack of discipline as the voters become harder to manipulate. In the second section the chapter turns directly to the 10 EU member states of the CEE region and examines whether such cycles can be observed in these countries. Finally, differences in the fiscal performances of leftist and rightist governments in the region will be analyzed.

2 The theory of political business cycles

Political business cycles mean that there is a strong connection between politics and the economy: the cyclicity of politics adds excessive volatility to economic fluctuations. There are two main branches of the field of research examining this connection. The first one is called the theory of *opportunistic political business cycles*. This assumes that the main goal of politicians is to gain power and to remain in office as long as possible, and they have an incentive to manipulate the economy because this provides more popularity (and therefore more votes) to them. These models do not involve ideological differences between the politicians; instead, they put the emphasis on their common motives. The other group of models concerns the so-called *partisan political business cycles*. These models put the ideological differences omitted by the opportunistic models in the center of analysis. According to this theory, politicians have their core electorate and they cannot neglect the interests of these voters. Thus, leftist parties (whose traditional electorate is the working class) run a pro-growth economic policy with less emphasis on low inflation, while the rightist parties (whose core voters come from the upper classes) are in favor of an economic policy promoting price and fiscal stability. This means that the alternation of leftist and rightist governments changes the economic policy significantly, and this adds an element to the economic fluctuations.

This section will first discuss the theory of opportunistic political business cycles, to be followed by the scrutiny of partisan models. After the theoretical background the main empirical findings in the literature are also summed up. There are significant differences between countries, so the third part of the section tries to shed some light on the causes of these differences.

The body of literature in this field is really wide. Some of the papers are about formalized models that can explain this phenomenon, while others provide the empirics. There are also general surveys like Drazen (2000), Gautier (2003), or Benczes and Ürögdi (2008) that cover the development of the whole area. Political business cycles also frequently appear in economic policy textbooks such as Alt and Chrystal (1983), Mosley (1984), Hibbs (1987), or Acocella (1998).

2.1 *The opportunistic models*

The first formalized model of opportunistic political cycles was provided by William D. Nordhaus (1975). This model—although widely criti-

cized—is still seen as the starting point of this wave of theory. The model assumes that the politicians are *purely opportunistic*: their only goal is to gain (and remain in) power. On the other hand, the electorate is also concerned about the state of economy *without any ideology* in mind. They dislike unemployment and inflation as well, and if the government is able to keep these at a low rate, the people vote in their favor. If not, they vote for the opposition. Another key assumption is that the voters are *myopic* (they cannot foresee what will really happen after the election; they only care about the present and near past) and they have a *short memory*. These properties are all important for the model's explanation of the political business cycles, meaning that the voters can be influenced by a pre-election expansion in economic policy, because they cannot see that the expansion will be followed by a restriction after the ballot. And their short memory means that this can happen again and again, because by the next election they will have forgotten that they were cheated the last time.

The engine of the economic side of the model is an *expectation-augmented Phillips curve* (details can be seen in Box 2.1). The voters dislike unemployment and inflation; therefore, the government wants to keep them at bay, but there is a trade-off between them. So, lower unemployment means higher inflation. The voters have *adaptive expectations* about the inflation: if there is a monetary shock, the increasing inflation will also raise their inflation expectation, which increases the future rate of inflation further. This means that if there is a monetary expansion (which decreases unemployment), then the inflation increases further in the longer run than in the short run. This is also vital for the cyclical economic policy to work.

Box 2.1. The Nordhaus (1975) model.

The economy is described by a Phillips curve:

$$u_t = \bar{u} - \gamma \cdot (\pi_t - \pi_t^e)$$

where u_t is the unemployment rate in period t , $\bar{u}$ is the natural rate of unemployment, π_t is inflation in period t , π_t^e is inflation expected to period t , and the positive parameter γ shows the trade-off between unemployment and inflation. This equation means that unemployment will be lower than its natural rate only if inflation exceeds its expected level. The government uses monetary policy to set the optimal unemployment–inflation combination.

The voters have adaptive inflation expectations:

$$\pi_t^e = \pi_{t-1} + \lambda \cdot (\pi_{t-1} - \pi_{t-1}^e)$$

where λ is a parameter between 0 and 1 that shows how much the past mistakes in forecasting influence the current expectations.

There are two candidates. The politicians have no ideology; they only wish to maximize the vote-function

$$V_t = \sum_{s=0}^t [\beta^{t-s} \cdot g(u_s; \pi_s)]$$

where the $g(u_s; \pi_s)$ function describes the preferences of the voters, and the discount factor β is between 0 and 1. The voters dislike both unemployment and inflation (formally:

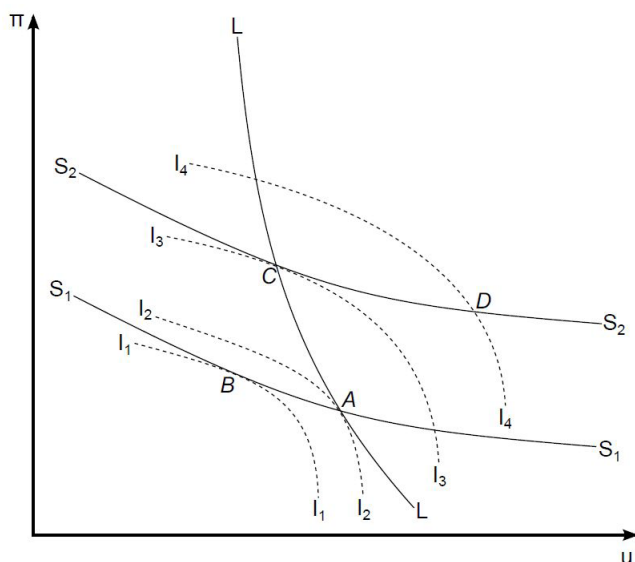
$$\frac{\partial g(u; \pi)}{\partial u} < 0 \text{ and } \frac{\partial g(u; \pi)}{\partial \pi} < 0)$$

Their voting decision is based only on past and present experience about the government's economic policy and its achievements (only past periods appear in the V_t vote function). They also gradually forget the past.

The timing of elections is exogenous (the government has to adjust the economic policy to the date of ballots, because they are not free to adjust the elections to the economic performance).

The basic concept of the Nordhaus-type cyclicalities can be seen in Figure 2.1. The LL curve is the long-run Phillips curve, while the S_1S_1 and S_2S_2 curves are short-run Phillips curves. As it has been said before, the long-run inflation costs of a reduction in unemployment are higher than its short-run costs; therefore, the LL curve is steeper than the S_1S_1 and S_2S_2 curves. The I_1I_1 , I_2I_2 , etc. dashed curves are social indifference curves. As people dislike both unemployment and inflation, their utility is higher on the I_1I_1 than on the I_2I_2 curve and so on.

Figure 2.1. The Nordhaus-type political business cycle.



The social optimum lies where the LL curve is tangent to the indifference curve representing the highest achievable welfare (point A). But at this point there is a temptation for the policymakers: with a monetary expansion they can move the economy from A to B. Unemployment can be lowered, while the great majority of the full inflation costs of this expansion appear only with delay. Point B seems better for the people; this increases the popularity of the government. If this expansion is timed directly before an election, it makes it more probable for the incumbents to be re-elected. But with a little lag the slight increase in inflation begins to raise the inflation expectations, which increases the inflation further (the short-run Phillips curve shifts upwards). This continues until the economy gets back to the long-run Phillips curve (point C). At this point the inflation is much higher than in the starting point, and what is more: it represents a lower level of social welfare. So with the overall costs of expansion the citizens are worse-off, even if the expansion seems to be socially beneficial in the short run.

To move the economy back to the social optimum (and to make another pre-election boost possible) the second part of the cycle must come as well. A restriction follows the elections to break down the infla-

tion expectations, which is needed to a disinflation. The unemployment increases immediately (point D), and the inflation expectations slowly start to adjust to the restrictive monetary policy (the short-run Phillips curve shifts downwards). By the time of the next pre-election campaign the economy finds itself at point A again.

This is the full cycle that becomes possible because the voters do not foresee that a restriction will follow the pre-election expansion to fight its long-run inflation costs. And if the voters are not just myopic, but also as forgetful as assumed in the Nordhaus model, this can happen again and again.

This model has been *widely criticized* on several grounds. These critiques paved the way to newer waves of theoretical work in this field. First, the voters are not just myopic, but they also have only a short memory in the Nordhaus model, so they can be repeatedly cheated. This is in contrast with the wave of macroeconomics based on rational expectations and utility-maximizing economic actors that gained power in the 1970s and 1980s. Newer models of opportunistic political business cycles assume that the voters are rational, and these models seek other sources of possible cyclicity in the economic policy. Second, the Nordhaus model assumes that there are no ideological differences between the political parties, which is also clearly a strict assumption. This can be rephrased in such a way that the model puts the emphasis solely on the swing voters who can be convinced with economic performance, because they are not committed ideologically. In reality the different parties cannot afford not to pursue the interests of their core electorate. The so-called partisan models try to grasp these differences between leftist and rightist parties. Third, in the Nordhaus model the government influences the economy through monetary policy. In the last few decades the central banks became independent from the government in all the developed countries, so the government is not able to use monetary policy to achieve its goals. Therefore, since the end of the 1980s the researchers of political business cycles turned their attention from monetary to fiscal policy that is still in the hands of politicians.

The second generation of political business cycle theories assume rational voters who maximize their expected utility. The most important such model was presented by Persson and Tabellini (1990), who argued that voters should have *rational inflation expectations*, that is, they use all available information in forming these expectations. Contrary to the Nordhaus model, the voters are *forward-looking*; they vote for the candidate who maximizes their expected utility. This means that irrationality cannot be used to explain the cycles in economic policy; instead, the authors propose *information asymmetries* as reasons of the phenomenon. They assume that

the trade-off between unemployment and inflation (the slope of the Phillips curve) depends on the *competences of the government*. These competences are known by the incumbents themselves, but the electorate does not have direct information about them (details in Box 2.2).

Box 2.2. The Persson and Tabellini (1990) model.

The competence-augmented Phillips curve looks like the following:

$$u_t = \bar{u} - \gamma \cdot (\pi_t - \pi_t^e) - \varepsilon_t$$

where ε_t is the competence parameter of the government. This parameter follows a first-order moving average process:

$$\varepsilon_t = \phi_t + \phi_{t-1}$$

where ϕ_t and ϕ_{t-1} are random variables with 0 expected value. All other variables are as before, so we can compare this to the Nordhaus model. If the incumbent government is competent, then they can boost the economy (lower the unemployment) with relatively little inflation costs, while if they are incompetent, the inflation costs are much higher. The ε_t parameter changes over time, which means that the competences needed to meet economic challenges change as the challenges themselves change. But, there is persistence in ε_t , so if a government successfully solved economic problems in the past, it is more probable that it can solve such problems in the future as well.

The main problem comes from the fact that the voters are not aware of the politicians' exact current level of competence (they do not know the exact slope of the Phillips curve), but obviously they would like to have a competent government in power. So, if the incumbents proved to be competent in the past, then they have an incentive to maintain this pretense even if they know that they are less able to meet the current economic challenges than they were in the past. To do so, they may need to run an economic policy before the election that is much more expansionary than expected. This decreases unemployment, which can be seen immediately by the electorate, while the inflation costs (possibly much higher than anticipated) appear only with a delay. The low unemployment rate and the high level of past

competence make the voters think that the government is still competent, which makes it more probable for the incumbents to win the elections.

Persson and Tabellini's model, therefore, provides a theory of political economic cycles with rational behavior of voters. But another critique of the Nordhaus model is valid for their work as well. They also assume that the government controls the economy through monetary policy. It was Rogoff and Sibert (1988) and Rogoff (1990) who put the emphasis on fiscal policy instead and introduced the term "political budget cycles."

In this case, voters are preoccupied with personal and public consumption and public investment, instead of unemployment and inflation. Similarly to Persson and Tabellini (1990), the politicians differ in their competences; some of them are more able to run a successful economic policy (provide more benefits with less costs) than others. Besides the emphasis on fiscal policy, another important difference from earlier models resides in the objectives of the government: the politicians are not purely opportunistic; they care about social welfare as well. Box 2.3 shows the details of the model's assumptions.

Box 2.3. The Rogoff (1990) model.

Voters try to maximize their expected utility that largely depends on the government's performance:

$$\Gamma_t = \sum_{s=t}^T E_t [U(c_s, g_s) + V(k_s + \eta_s)] \cdot \beta^{s-t}$$

where c is personal consumption, g is public consumption, k is public investment, η is the utility that comes from the non-economic properties of the government, and β is the discount factor.

The citizens consume their disposable income:

$$c_t = y - \tau_t$$

where y is their income, and τ is a lump-sum tax.

The "production function" of government spending is

$$g_t + k_{t+1} = \tau_t + \varepsilon_t$$

where ε shows the competence of the government. This means that a more able government can provide a wider array of goods and services to the citizens out of the same amount

of budget revenues. They have to sacrifice less future public investments to increase current government consumption or reduce taxes. This also shows the trade-off that the society faces: the more tax people pay, the more (useful) government spending can take place, but personally they can consume less. The competence parameter follows a first-order moving average process:

$$\varepsilon_t = \alpha_t + \alpha_{t-1}$$

where α has two possible values (“high” and “low”). So, there is persistence: a government that was more competent in the past has better chances to stay so in the future as well.

The non-economic properties of the government also follow a first-order moving average process:

$$\eta_t^i = q_t^i + q_{t-1}^i$$

where q is a random variable.

The objective function of the government is

$$E_t^I(\Gamma_t) + \sum_{s=t}^T \beta^{s-t} \cdot X \cdot P_{s,t}$$

where $E_t^I(\Gamma_t)$ is how the incumbent sees the future expected utility of the citizens, while the second term shows the prestige that the politicians gain from being in power. X is the effect of one year in power on the prestige, and $P_{s,t}$ is the probability that the incumbent in period t will also hold power in period s .

The fact that the model’s politicians care for social welfare has an important role in explaining their behavior regarding the political budget cycles. The competent governments know that they can cope with the future costs of an expansionary fiscal policy, so they start a spending boost or tax reduction before the elections. The citizens feel the beneficial consequences of increased public or private consumption, but they will recognize the results of cutting public investments only later. Less competent governments could do the same, but they are unwilling to do so, because they know that the social costs of less public investments outweigh their utility from remaining in power.

Therefore, only (currently) competent governments will start pre-election expansions. This means that, according to the model, putting

cycles in fiscal policy is a socially efficient method for the government to signal its high level of competence to the voters. This is what resolves the information asymmetry between politicians and electorate.

However, the result that only competent governments run cyclical economic policy seems rather unrealistic. First, this would mean that all governments who start a pre-election expansion have to be competent ones, and because the voters would like to have a competent government in power, they would not substitute a new one with unknown level of competence for the incumbents. In reality, we can frequently witness that governments lose elections even if they start a spending boost or a tax reduction before the vote. Their non-economic performance can break up the contradiction: even if a government is efficient in economic policy, it still can lose the elections if it shows bad performance in other fields of politics. Second, it is quite questionable that politicians have clear and realistic ideas about their level of competence, and the less able ones are willing to sacrifice their chances of remaining in office for the benefits of the society.

The *third generation* of opportunistic political business cycles assume instead that even the politicians do not have full information about their competence. In these models neither the government nor the citizens can foresee how much investment they must give up (how much future cost they must bear) for a current increase in government spending or decreasing taxes. Therefore the difference between the behavior of more and less competent governments disappear: they all have an incentive to start an expansion before the elections, because that is how they can remain in power, and there is a chance that the future costs of the expansion will not be that high.

All these aforementioned models analyze the cyclical economic policy that stems from the governments' wish to increase their chances of winning the upcoming elections. The next subsection explores the other branch of political business cycle theory before turning to the empirical findings about the opportunistic models.

2.2 Partisan models

The theory of partisan political business cycles goes back to Hibbs (1977). The main idea is that there is a significant difference between the core electorates of leftist (social democratic) and rightist (conservative) governments. Traditionally the majority of the social democratic voters come from social groups with lower (labor) incomes. Therefore their main interest lies in economic growth and employment, because these provide security and higher welfare for them. On the other hand, the upper layers of the society

mostly vote for conservative parties. These citizens usually have savings and property; capital incomes have a significant role among their revenues. Therefore they are less threatened by unemployment, but a stable economic environment with low inflation is really important for them.

The main point is that the different parties cannot afford not to represent the *interests of their core electorates*, because if they do not do so, they can lose these voters. Even if a traditionally conservative voter will be unwilling to vote for a social democratic party (and vice versa), it is still possible that he will not go voting at all if he is not satisfied with the performance of his party. So to maintain the activity and participation of their voters the parties have to pursue their economic goals. This leads to important differences between the economic policy followed by rightist and leftist governments.

A simple but enlightening model for this phenomenon was provided by Alesina (1987). There are two parties in the model who set their monetary policies based on their economic objectives (inflation and unemployment). Naturally, there is a trade-off between these goals shown by a Phillips curve. The rational voters form their expectations based on the probabilities of possible election outcomes. As there is uncertainty in these outcomes, the realized monetary policy after the elections will differ from the expected one, and the unexpected inflation or disinflation will affect the real economy and the level of unemployment as well. A simplified version of the model is presented in Box 2.4.

Box 2.4. The Alesina (1987) model.

Both parties would like to minimize a cost function:

$$c_L = (\pi_t - \bar{\pi}_L)^2 + b_L \cdot u_t \quad \text{and} \quad c_R = (\pi_t - \bar{\pi}_R)^2 + b_R \cdot u_t$$

where $\bar{\pi}_L > \bar{\pi}_R > 0$ are the inflation goals declared by each party, and $b_L > b_R > 0$ are the relative weights of unemployment in their objective function. These assumptions follow what we said above about the main economic goals of leftist and rightist governments: the former puts a higher emphasis on growth and employment, while the latter prefers a lower inflation rate. The voters have similar objective functions:

$$c_i = (\pi_t - \bar{\pi}_i)^2 + b_i \cdot u_t$$

They vote for the party whose parameters are closer to their own preferences.

Similarly to the Nordhaus model, a simple expectation-augmented Phillips curve describes the economy:

$$u_t = \bar{u} - \gamma \cdot (\pi_t - \pi_t^e)$$

Using the Phillips curve to substitute $\bar{u} - \gamma \cdot (\pi_t - \pi_t^e)$ for u_t in the cost functions, the minimization problems can be solved:

$$\pi_L^* = \bar{\pi}_L + \frac{b_L \cdot \gamma}{2} \text{ and } \pi_R^* = \bar{\pi}_R + \frac{b_R \cdot \gamma}{2}, \text{ where } \pi_L^* > \pi_R^* \text{ due to our assumptions.}$$

It can be seen that both parties have an incentive to make inflation higher than what they declare as optimal, because this allows them to decrease unemployment, which is also important for them.

Voters form their inflation expectations based on the expected outcome of the elections:

$\pi^e = P \cdot \pi_L^* + (1 - P) \cdot \pi_R^*$, where P is the probability that the leftist party will be the winner.

Because $\pi_L^* > \pi_R^*$, the realized inflation will be higher than expected if the leftist party is elected; this leads to lower unemployment:

$$u_L = \bar{u} - \gamma \cdot (1 - P) \cdot (\pi_L^* - \pi_R^*) < \bar{u}$$

On the contrary, if the rightist party wins, lower inflation and higher unemployment follow the vote:

$$u_R = \bar{u} - \gamma \cdot P \cdot (\pi_R^* - \pi_L^*) > \bar{u}$$

These effects fade as the inflation expectations adjust to the political situation, therefore in the second half of election cycles there is no large difference between unemployment rates, but this goes together with higher inflation if a social democratic party is ruling.

Although this model sheds light on how the different values lead to different economic policy, it also has the assumption that the government can manipulate monetary policy to achieve the preferred economic situation. This is not a plausible assumption these days when the central banks in developed countries are independent from the government. However, the problem can be put in a fiscal framework as well. In this case the leftist governments will promote higher government spending to pursue higher employment (public works, public investment projects) and to boost economic growth, while the conservative ones will concentrate on stable fiscal

policy not to cause an inflationary pressure. If there are changes in the governments (the structure of society is not totally stable, there are swing voters) this means a kind of cyclicity: the elections lead to changes in the economy due to the shift of economic policy.

The difference between the economic policies of different governments can be seen in the empirics as well. Hibbs (1987) showed that unemployment tends to be systematically lower, the growth rate of incomes systematically higher under Democratic presidents than under Republican ones. As Faust and Irons (1999) put it: there is a rule of thumb that separates the Democratic and Republican presidencies since World War II: in the first eight quarters of the Republican presidential cycles a recession nearly always started. The one exception is the second term of Ronald Reagan; and since their study the presidency of George W. Bush also proved to be an exception, though the growth performance in his eight years was significantly weaker than under Clinton.

Alesina and Roubini (1992) examined 18 OECD countries and also found that in the two-party political systems the ideology of the government can be seen in the inflation and the real economy as well.

2.3 Cross-country differences

There are many studies that analyzed whether the theory of political business cycles can be justified by empirics or not. Nordhaus (1975) himself brought some data from the most developed countries and found that while the experience of France, Germany, New Zealand, and the US fits his theory, some other countries (Australia, Canada, Japan, and the UK) contradict it. On the other hand, Golden and Poterba (1980) have not found the theory proven by the American data. The aforementioned study of Alesina and Roubini (1992) also arrived at mixed results. They found some cyclicity in the behavior of inflation in their analysis of 18 OECD countries, while this was not the case for output and unemployment.

In the case of developing countries there is stronger evidence for cyclical economic policy. Block (2002) analyzed 44 African nations and found a large regular monetary expansion at the time of elections. In the year of the votes the amount of money usually increased 4 to 4.5 percentage points faster than usual, which lead to a 6 to 8 percentage point increase in inflation in the next year. This equals to a one-third increase compared to the usual inflation rate. In African countries central banks are much less independent than in the developed world, so monetary policy still can be used to increase the popularity of the government. Schuknecht

(2000) used the data of 24 developing countries to show the presence of fiscal cycles as well. According to his study the governments usually use the expenditure side of the budget to boost the economy before the elections.

The developed countries provide mixed results in budget cycles as well. Andrikopoulos, Loizides, and Prodromidis (2004) found no significant difference between the election and non-election year data of 14 EU member states in the 1970 to 1998 period. On the other hand, Mink and de Haan (2006) have demonstrated that in newer data such differences can be seen even in the European countries. This difference may come from the fact that in the 1990s the analyzed countries had to follow strict stabilization policies to prepare for the Eurozone membership, while after introducing the euro, these incentives became weaker.

Table 2.1 shows *cyclically adjusted primary balance*¹ data for the 12 founding members of the Eurozone. The data intentionally does not cover the recent years, because huge deficits that appeared in several countries including Ireland, Portugal, and Spain due to the economic crisis would distort the results, as these deficits are largely independent from elections.² Snap elections (when an election becomes necessary because the government resigns or the parliament dissolves) are counted as non-election years. The theory of opportunistic political business cycles assumes that the government intentionally manipulates the economy to increase its chance of winning the upcoming election. If there is a sudden collapse of government, there is no chance of such behavior to evolve.³ It can be seen that in practically all countries (with the exception of Portugal) there is a clear pattern to the difference between years with and without ballots: the *fiscal situation is worse* in election years. The difference is moderate in most countries, but in nearly half of the sample it reaches 1 percentage point. The Portuguese exception largely comes from the fact that the average primary balance was significantly better between 1995 and 1999 than between 2000 and

¹ The adjustment is based on the trend GDP. In the potential-GDP-based time series there are some missing data.

² The use of structural balance would partially solve this problem, but the structural balance data are available only for a shorter time period (since 2001).

³ Those early elections that take place only a few months before the originally planned date (e.g., 2006 in the Netherlands or 2007 in Greece) are counted as normal ballots, because the government knows that there will be an election in the near future.

2008 (0.2 percent compared to -1.9 percent). Both the regular elections took place in the former period, while there were only two extraordinary ballots in the latter.

Table 2.1. Political budget cycles in the 12 original members of the Eurozone, 1995–2008.

Country	Number of regular elections*	Average cyclically adjusted primary balance in election years	Average cyclically adjusted primary balance in non-election years
Austria	2 ('99, '06)	0.6%	0.9%
Belgium	4 ('95, '99, '03, '07)	4.7%	5.0%
Finland	4 ('95, '99, '03, '07)	3.1%	4.7%
France**	4 ('95, '97, '02, '07)	-0.6%	-0.1%
Germany	2 ('98, '02)	0.1%	0.3%
Greece	4 ('96, '00, '04, '07)	-0.4%	0.4%
Ireland	3 ('97, '02, '07)	0.5%	2.1%
Italy	2 ('01, '06)	1.1%	3.2%
Luxembourg	2 ('99, '04)	1.5%	2.8%
Netherlands	3 ('98, '02, '06)	2.2%	2.3%
Portugal	2 ('95, '99)	0.3%	-1.3%
Spain	3 ('00, '04, '08)	-0.6%	1.6%

Source: AMECO database.

Notes: *Snap elections (1995 in Austria, 1996 in Italy and Spain, 2002 in Austria and Portugal, 2003 in the Netherlands, 2005 in Germany and Portugal, 2006 in the Netherlands, 2008 in Austria and Italy) are counted as non-election years. **Both parliamentary and presidential elections.

To sum up the results, there is a strong political cyclicity in economic policy in the developing countries, while the data are quite mixed for the developed world. In some time periods there are no political business cycles in these countries, while they appear in other years. But even in these periods the cycles are much weaker than in the developing regions of the world.

However, the interesting results of Brender and Drazen (2003, 2005) show that it is not the economic development that matters, but the democratic routine that the citizens have. In newer democracies the voters do not have enough knowledge about how the democratic process works, what incentives rational politicians have, and how they can use economic policy to manipulate the economy and therefore the short-run well-being

of the citizens. So, fighting the political business cycles is a *learning process*; as voters gather routine in democracy, they become more resistant to the manipulation attempts of politicians. Of course, time in itself is not enough. A wide array of *institutions* from fiscal rules to a strong and independent press is also important in forming this kind of routine.

As it could be seen above, the different generations of political business cycle models offer different explanations for the phenomenon that governments tend to run a more expansionary economic policy before the elections. The first models assume that the irrationality of voters is responsible for this cyclicity, while the newer ones show that the presence of information asymmetries can explain it even in a fully rational environment. Meanwhile, the attention of the political business cycle theory turned from monetary policy towards fiscal policy.

The second part of this study narrows the analysis solely on political budget cycles. It examines whether the signs of opportunistic or partisan cycles can be observed in the fiscal data of Central and Eastern European countries.

3 Empirical findings for the CEE region

The Central and Eastern European countries provide an interesting field of research in the case of political business cycles, because they are all quite *new democracies*, and they all stepped onto the path of democracy at approximately the same time. Still, as it can be seen below, there are differences between the countries.

Concentrating on fiscal policy the study uses *cyclically adjusted primary balance* data from the AMECO database, as this is mainly what the government is able to influence in the short run. The interest payments are given at any point in time, therefore all intentional short-run fiscal expansions and restrictions should be seen in the primary balance. Cyclical adjustment is also important, because in this way the results of economic policy decisions can be separated from the fiscal effects of economic growth.

The time period under analysis starts with 1995 and ends with 2008. The years since 2009 are intentionally omitted. As the examined period is relatively short, the large deficits of the past few years would strongly influence the results and probably obscure all pre-crisis differences between election and non-election years or leftist and rightist governments. For the same reasons the AMECO time series that begin with 1995 are perfectly

suitable for the analysis, because the first years after the regime transition also saw some large imbalances. The year 1996 is also excluded in the case of the Czech Republic and Slovenia, because the large deficits of these years prove to be outliers (they are at least four times higher than the average of later years), and they would only distort results.

3.1 *Opportunistic political business cycles*

Table 2.2 shows the cyclically adjusted primary balance data for the 10 Central and Eastern European EU member states.⁴ As nearly all of them are parliamentary democracies, only the legislative elections are taken into account. The only exception is the half-presidential Romania, where there is a division of executive powers between the government and the president. However, before 2008 the presidential votes took place together with the legislative elections, so this also does not alter the database. It should also be noted that (as it was discussed above) fiscal policy cannot adjust to sudden extraordinary ballots. Therefore, such cases (1995 in Estonia and Latvia, 1997 in Bulgaria, 1998 in the Czech Republic and Latvia, 2007 in Poland) are considered as non-election years.

It can be seen from Table 2.2 that in 9 out of the 10 countries the *primary balance is usually worse in election years* than otherwise. Bulgaria is the only exception. There are two normal elections (2001 and 2005) in the sample period. This low number can obviously be responsible for the strange result, but it is still true that in one of these election years (2001) Bulgaria had its third largest primary surplus in the whole period (6.4 percent of the GDP), which is far above the previous and next year's data. Of course, the fact that there was only one other normal election in the examined time period amplifies this year's effect on the averages.

In most of the countries there are only slight differences due to the ballots. The primary position was more than 1 percentage point worse in election years than in non-election years only in Romania and Hungary: the difference is 2.7 percentage points and 4.1 percentage points, respectively. In three other countries (Estonia, Latvia, and Slovenia) the difference is 0.9 percentage point.

The election year's primary balance can also be compared to the previous and the next year to see whether a fiscal shock occurred. In 24 out

⁴ Croatia is omitted due to lack of data.

Table 2.2. Political budget cycles in the CEE countries, 1995–2008.

Country	Number of regular elections*	Average cyclically adjusted primary balance in election years	Average cyclically adjusted primary balance in non-election years
Bulgaria	2 ('01, '05)	4.2%	4.0%
Czech Republic**	3 ('96, '02, '06)	-3.4%	-2.8%
Estonia	3 ('99, '03, '07)	-0.6%	0.3%
Hungary	3 ('98, '02, '06)	-4.4%	-0.3%
Latvia	2 ('02, '06)	-2.2%	-1.3%
Lithuania	4 ('96, '00, '04, '08)	-2.4%	-2.3%
Poland	3 ('97, '01, '05)	-1.0%	-0.7%
Romania	4 ('96, '00, '04, '08)	-2.9%	-0.2%
Slovakia	3 ('98, '02, '06)	-3.2%	-2.9%
Slovenia**	4 ('96, '00, '04, '08)	-1.3%	-0.4%

Source: AMECO database.

Notes: *Snap elections (1995 in Estonia and Latvia, 1997 in Bulgaria, 1998 in the Czech Republic and Latvia, 2007 in Poland) are counted as non-election years. **1996–2008.

of 31 regular elections (77.4%) the *primary balance worsened* from the previous year to the year of the elections. It seems that while the governments were willing to increase spending when the election was coming, they were somewhat less ready to stabilize the budget afterwards. In only 17 out of the 31 cases (54.8%) did the deficit decrease or the surplus increase from the election year to the next.

The results are mostly similar if the cyclically adjusted net lending is analyzed instead of the primary balance or if a longer time series, from 1995 to 2012, is used. Table 2.3 remains with the cyclically adjusted primary balance to make it comparable with Table 2.2, but it includes the years 2009 to 2012 as well. Due to the adjustment the direct fiscal effect of the recession does not appear in the data, but this is not true for the discretionary expansionary policies that the governments launched to fight the economic crisis. In this longer period there are three other extraordinary ballots (2011 in Latvia and Slovenia, 2012 in Slovakia) that should be counted as non-election years if one wishes to examine the presence of opportunistic political business cycles.

Table 2.3. Political budget cycles in the CEE countries, 1995–2012.

Country	Number of regular elections*	Average cyclically adjusted primary balance in election years	Average cyclically adjusted primary balance in non-election years
Bulgaria	3 ('01, '05, '09)	1.5%	3.0%
Czech Republic**	4 ('96, '02, '06, '10)	-3.5%	-2.9%
Estonia	4 ('99, '03, '07, '11)	0.1%	0.6%
Hungary	4 ('98, '02, '06, '10)	-3.1%	0.8%
Latvia	3 ('02, '06, '10)	-2.6%	-1.3%
Lithuania	5 ('96, '00, '04, '08, '12)	-2.0%	-2.6%
Poland	4 ('97, '01, '05, '11)	-1.5%	-1.5%
Romania	5 ('96, '00, '04, '08, '12)	-2.4%	-1.4%
Slovakia	4 ('98, '02, '06, '10)	-4.1%	-3.2%
Slovenia**	4 ('96, '00, '04, '08)	-1.3%	-1.5%

Source: AMECO database.

Notes: *Snap elections (1995 in Estonia and Latvia, 1997 in Bulgaria, 1998 in the Czech Republic and Latvia, 2007 in Poland, 2011 in Latvia and Slovenia, 2012 in Slovakia) are counted as non-election years. **1996–2008.

If the data from Tables 2.2 and 2.3 are compared, it can be seen that in the great majority of the countries the fiscal position worsened due to the discretionary policies the governments started to promote as a recovery from the economic crisis. There was an improvement in Estonia as well, but the most remarkable exception is Hungary where the governments had to run a pro-cyclical economic policy during the crisis to regain investors' trust shaken by the deficit and debt problems.

As can be seen from Table 2.3, in 8 of the 10 countries the cyclically adjusted primary balance is worse in the election years than in the non-election years. Only Lithuania and Slovenia show a different picture; in Poland there is also a slight appearance of the budget cycles obscured only by the rounding.

3.2 Partisan cycles

Examining the partisan political budget cycles is much less straightforward in this region. The theory was basically created for two-party political

systems, while in Europe there are usually much more parties—mainly due to the proportional voting mechanisms used in many countries of the continent. What is more, the ideology of parties in the new democracies is usually less stable and clarified, and frequently follows a different pattern than in Western Europe.

First, the primary political ideology (conservative, liberal, social democratic) of the different parties was determined by the parties' self-definition along with their European or international affiliation. So, the members of the European People's Party, the European Conservatives and Reformists, or the Europe of Freedom and Democracy were counted as conservatives, the members of the Progressive Alliance of Socialists and Democrats as social democrats, and the members of the Alliance of Liberals and Democrats for Europe as liberals. In the case of coalition governments when the members of the coalition came from different party groups, the government was classified based on the ideology of the major party and the prime minister. This three-pole system then had to be turned into a two-pole classification. It is clear that the conservative governments were counted as rightist and the social democratic ones as leftist. The liberal governments were classified based on the other coalition members and the major liberal party's willingness to co-operate with conservative and social democratic parties.

Because each year's budget is accepted in the previous year, and a newly elected government has full authority only over the next year's budget, each government's period was set to start with the year after the election. Only the 1995 to 2008 period is examined, because it was practically a worldwide phenomenon that governments launched recovery programs to fight the economic crisis—no matter whether they were conservatives or social democrats. This simply diminished the difference between the fiscal performance of leftist and rightist governments.

The results can be seen in Table 2.4. According to the applied classification, Estonia and Latvia had no leftist governments in the examined period. In three of the other eight countries the leftist governments on average had significantly worse primary balances than the rightist ones. The difference is in all three cases at least 2 percentage points. In the other five countries the contrary can be seen. Lithuania shows the most striking picture, but this is only caused by one year: a conservative government ruled in 1997, when the primary deficit hit 11.5 percent of the GDP. Without this one year the average primary balance of the conservative side would be only -1 percent. The case of Romania is similar, whose result is largely due to the 9 percent 2008 primary deficit of the liberal-conservative government. In the remaining three countries the difference

Table 2.4. Partisan fiscal differences in the CEE countries, 1995–2008.

Country	Average cyclically adjusted primary balance under leftist governments	Average cyclically adjusted primary balance under rightist governments
Bulgaria	3.4%	5.6%
Czech Republic*	-2.8%	-3.1%
Estonia	n.d.	0.1%
Hungary	-1.7%	0.3%
Latvia	n.d.	-1.4%
Lithuania	-1.8%	-3.6%
Poland	-0.5%	-1.1%
Romania	-0.2%	-1.5%
Slovakia	-4.1%	-2.1%
Slovenia*	-0.1%	-0.9%

Source: AMECO database. Note: *1996–2008.

between the fiscal positions of rightist and leftist governments are below 1 percentage point. Yet, it is true that the overall picture does not show such general partisan differences in the Central and Eastern European countries as suggested by the models.

4 Conclusion

As it has been demonstrated, there are mixed results about the two types of political business cycles in the Central and Eastern European EU member states. There is no sound proof of a traditional leftist–rightist rupture in fiscal policy, although in Bulgaria, Hungary, and Slovakia the social democratic governments produced a significantly worse fiscal position than the conservative ones.

The study has found much stronger results in the case of opportunistic models. In eight or nine of the ten countries the fiscal position is usually worse in the years of elections than otherwise, which is probably the result of expansionary policies timed to the ballots. There are at least two interesting questions. The first is why are there not different results (significantly larger cycles) in Central and Eastern Europe than in the Eurozone. The data from Tables 2.1 and 2.2 show fairly similar pictures

from the aspect of cyclicity. One important remark is that the Western European countries produce the same (or smaller) size of political budget cycles with a much better average fiscal position. So in their case there is more space for fiscal loosening before the elections without serious long-run sustainability consequences.

The second question is whether these cycles can disappear in the near future. The economic crisis has obviously mixed many things up; some countries (like Latvia, Lithuania, or Romania) had huge deficits in 2009 and 2010, while Hungary, for example, had to maintain a strict (and therefore pro-cyclical) fiscal policy in the crisis as a cost of earlier sustainability problems. The important issue is what is learnt from the experience and how these countries—both the politicians and the citizens—form their fiscal policy when the crisis is over.

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CHAPTER 3

The Strategic Use of Public Debt in Central and Eastern Europe

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1 Introduction

For a long time, the study of political economy (PE) was limited to public choice theory (see especially the original works of Buchanan and Tullock 1962 and Olson 1965) and especially to the analysis of political business cycles (e.g., Nordhaus 1975). In the early nineties, however, an increasing number of mainstream economists engaged in a new stream of research within PE, which was dubbed as political economics. This emerging field was established as a combination of rational choice theory, public choice theory and the Lucas-type rational expectations based macroeconomics. Persson and Tabellini (2000:4) referred to political economics as a unified approach which “adopt[ed] the equilibrium approach of the macroeconomic theory of policy and exploit[ed] the tools of rational choice in analysing some of the classic problems in public choice.”

One of the most distinguishing characteristics of this unified approach was that it irrevocably split with the earlier general assumption of PE literature, i.e., the irrational and myopic actors; instead, it claimed that people behaved rationally, and everybody was an active participant either in the market as consumer or producer or in the polity as voter or politician. Consequently, the analysis of policy choice was placed into a rather abstract, deductive form, where all decisions were interpreted as an equilibrium of rational human actors' strategic interaction. Uncertainty and imperfect information have played a vital role in the models of political economics.

According to political economics, the motivation for political-strategic decisions of incumbent political actors—such as parties, coalitions, or politicians—on the level of budget deficit and debt can be highly different from that of a social welfare planner. In fact, a *political bias* prevents the emergence of a socially desired optimum. Fundamentally, there are two distinctive approaches in political economics that try to explain why first best decisions are discarded and, in turn, why there is a divergence between actual fiscal performance and the socially ideal (or optimal) outcome. The first is the so-called “political (or electoral) institutionalist” approach, which concentrates on the different dimensions and variables of the political system, such as the polarization of the political regime or even the type of the regime itself; the prevalence of strategic behavior in a given time or between time periods, etc. The second proposition is comprised of the so-called “fiscal (or budget) institutionalists,” who emphasize the active role of the formal and informal rules and procedures of the (annual) budgeting process from the preparation stage to the ex post checking phase. For the former, the budget institutions are given, while for fiscal institutionalists political incentives do not play a role, as these are considered stable (and not easily changeable) in the short and medium run.

The most often cited explanations for bias towards overspending can be grouped as follows: (1) government debt is used strategically in the present to constrain the choices of the new incumbents in the future (Alesina and Tabellini 1990); (2) coalitions may react too slowly in case of fiscal shocks due to a distributional conflict of consolidation costs (Alesina and Drazen 1991); (3) differences in political regimes can also be accounted for a deficit bias due to the tendency of proportional electoral systems and parliamentary regimes to associate “with more public goods, larger and more universalistic welfare programs, and a larger overall size of government” (Persson and Tabellini 2002:2); (4) the fragmentation of the political processes and the weakness of government (and/or the legislature) can lead to a permanent deficit and the accumulation of debt (Kontopolous and Perotti 1999); and (5) the decentralized nature of public budgeting (i.e., the drafting, the amendments, the decision, and the implementation), the lack of a firm-handed finance or prime minister, the lack of a coalitional agreement, and the absence of transparency can also contribute to the prevalence of deficit bias (Hagen 1992).

The current chapter focuses on the very first model, the model of “debt as a strategic variable.” After a critical review of the relevant literature, the debt dynamics of CEE countries will be analyzed within the framework of Alesina and Tabellini’s (1990) model. Since their model

concentrates exclusively on the increasing tendencies in the general government gross debt, only those countries and episodes have been selected for scrutiny which have convincingly demonstrated a worsening fiscal performance *over* the business cycle.

The chapter concentrates on the period 1995–2007, since the model of Alesina and Tabellini (1990) can be applied in normal times only. The first few years of the systemic change were evidently burdened with significant costs (not just economic but also social ones) due to the transformational recession (equaling to 12 to 50 percent of the GDPs of the countries under analysis), which in turn considerably restricted the room for fiscal maneuvering of the very first freely elected governments. As the analysis ends with 2007, it does not extend to the era of the current global economic and financial crisis, since governments might have decided to adopt discretionary policies not just because of electoral (or political) reasons—or at least, it would be extremely challenging if not impossible to disentangle politically-driven strategic motivations for debt-accumulation from those measures which were meant to cushion the perverse effects of the crisis.

The chapter claims that some political parties and coalitions in CEE did in fact use public debt as a strategic variable. Interestingly, by and large, whereas the Baltic states seemed to avoid the reliance on debt as a constraining device for future governments' actions, incumbents in Visegrád countries (i.e., the Czech Republic, Hungary, Poland, and Slovakia) accumulated debt, which then successfully narrowed down the room for (spending) manoeuvre of the incoming parties.¹

2 The strategic use of debt

In neoclassical theory, public debt serves as a buffer in the case of downturns in economic activity (due to war for instance). “It is desirable for the government to manage the public debt to avoid large random fluctuations in tax rates from period to period. This motivation accounts for the tendency of governments to run large real deficits during wars and recession but to run real surpluses in ‘good times’” (Barro 1997:543). That is, the

¹ Importantly, this chapter does not want to repeat the main findings of other chapters (especially the case studies) of this book. Instead, it concentrates on the intimate relationship between debt on the one hand and strategic political motivations on the other hand.

role of public debt is to ensure the smooth functioning of the economy and the tax system, and to act as a buffer if extraordinary circumstances arise. Consequently, in the process of debt accumulation, politics (or political motivations) has no role in neoclassical economics. However, Alesina and Tabellini (1990) have shown that the accumulation of debt can also result from strategic behavior; that is, indebtedness itself can be a strategic choice used by the alternating policymakers (or parties) in power. In turn, the strategic use of debt culminates in a higher than socially optimal equilibrium level of public debt.²

The prevalence of strategic choice (and as a consequence, policy distortions) seems to be a permanent and imminent characteristic of democracies where elections are, in fact, the source of uncertainty. The higher the chance to lose the next election, the more likely it is that incumbents are willing to increase spending and debt in the present. How much debt the incumbent is willing to take on is usually a question of ideological distance between the alternating parties in the various models of the literature.³ Consequently, it is not just the decreasing chance of being re-elected that points towards a strategic accumulation of debt but also the strong polarization of the party structure (Alesina and Tabellini 1990).

Public debt as the future legacy of the current government works then as an exogenous factor for the new incumbents, since by its use, the current executives are able to constrain the room for maneuver of their successors in future policy-making. The liabilities undertaken by the current government in the form of debt can become a burden for the future cabinet and therefore the successor may find itself in a strongly constrained (or distorted) situation in which the preferred policies cannot be pursued.⁴ In fact, the government which embarks on debt accumulation

² Importantly, for Alesina and Tabellini (1990) the reference point was still the normative theory of fiscal policy, i.e., the neoclassical tax smoothing concept. They, however, tried to create a positive theory, which can explain the non-applicability of the neoclassical explanation of budget deficit and debt under the circumstances of the empirical observations in the seventies and in the eighties.

³ Assuming that it is not office motivation what matters in policy making but partisan motivation.

⁴ It is probably worth stating that the theory of the strategic choice of debt accumulation has no similarities with the concept of political business cycles, although in both cases overspending before elections is a common phenomenon. In strategic choice theory, this does not mean the motivation of ensuring a higher chance to get re-elected which forces the current government to spend more, but the possibility that it will lose the next elections.

serves the interest of its own constituency, and by tying the hands of its successor it brings the electorates of the other party (the successor) in a worse situation than otherwise.

Box 3.1. The Alesina and Tabellini (1990) model in work.

Let us assume that party “A” is in power. However, due to the uncertainty with regard to the results of the next elections, it cannot be sure in its re-election. It knows, however, that if the voters favor party “B,” the successor would provide public good “b” in the future. As a corollary, party “A” has a strong incentive to supply more than the socially optimal public good “a” in the present at the expense of deficit and debt, by which the successor’s ability is limited significantly in providing “b” after the change in government. For the successor, therefore, the present commitment of future taxes is a valid and strong delimitation in its spending activities.

For the sake of clarity: if the two parties had the same preferences on the preferred composition of public goods (“a” = “b”), that is, the two parties do not show a difference in their ideology, no strategic choice of debt would prevail at all. However, in case of the prevalence of partisan motivation (divergence in ideology), the chance for strategic behavior increases if the degree of polarization in a (two-)party structure is higher.

Deficit and especially debt, therefore, can be interpreted as means in a struggle between policymakers with different preferences on the desired level or composition of public good(s). By assuming that policymakers follow a partisan motivation, Alesina and Tabellini (1990) tried to predict the equilibrium level of debt in the presence of strategic behavior. In their model a disagreement prevailed on the composition of government spending. That is, the preferences of the two policymakers (parties) differed substantially with regard to the kind of public good provided. Party “A” preferred public good “a” and party “B” chose public good “b,” representing the interest (taste) of their constituencies. The heterogeneity of interests and the emerging conflict on the provision of public goods pushed policymakers into non-optimal outcomes; that is, incumbent politicians had a rational temptation to use public debt in the present (i.e.,

before elections) strategically in order to constrain the room for choosing the preferred policies of the successor in the future—after elections (for details, see Box 3.1).

Box 3.2. The Tabellini and Alesina (1990) model.

In another study, Tabellini and Alesina (1990) turn to the voters (instead of parties) and claim that the more polarized individuals' preferences are, the higher the deficit and the debt. They assume that individuals act rationally and are fully informed; yet, a bias towards overspending still exists. The policies (and the spending on public good) preferred by the current majority (of voters) cannot be maintained in the future in case of government change, because the post-election majority will have a different preference on the composition of public goods. The current median voter, therefore, wants to get assured *now* (before elections) that his future consumption does not depend on the result of the forthcoming elections.

Although rational voters are aware of the fact that a balanced budget would be the optimal policy choice for the society as a whole, the current majority prefers a policy that is not socially optimal (i.e., deficit financing and debt accumulation). In fact, the authors use their argument to explain why there is a discrepancy between the results of opinion polls on fiscal discipline (people usually agree on the need for a balanced budget) and actual fiscal performance. The current majority can never fully internalize the costs of overspending, due to the uncertainty of election results. In the words of Tabellini and Alesina (1990:47): "Disagreement between current and future voters about the composition of future expenditure generates a sub optimal path of public debt."

It is worth emphasizing that Alesina and Tabellini (1990) wanted to defy the concept of fiscal illusion, too, by showing that fiscal deficit is not the result of voters' irrationality but the conflict of the heterogeneous interests of (rational) policymakers and consequently of their (rational) voters. That is, "it is the citizens' disagreement, rather than their myopia, that may generate a deficit bias in democracies" (Alesina and Tabellini

1990:404; for an outline of their opposition to the concept of fiscal illusion see *ibid.*).

In contrast to Alesina and Tabellini's (1990) famous classic model, Persson and Svensson (1989), in modelling the strategic choice of debt, focused on the different levels of spending on the *same* public good. By concentrating on the level of public expenditure and the related preferences on the level of spending, the authors contrasted the behavior of conservative governments (those in favor of a low level of public consumption) and left-wing (assumedly expansionist) governments. Generally speaking, conservative governments prefer tax cuts. However, studying fiscal policy in the US, Persson and Svensson (1989) argued that the decrease in revenues was not combined with a consecutive decline in spending under conservative cabinets; instead, deficit and debt increased. Their explanation was that conservatives used the debt strategically in order to tie the hands of their likely successors, the expansionist liberals.⁵ Paradoxically, it is the conservative government which embarks on deficit financing and it does so not because of the usual Keynesian argument (counter-cyclical fiscal policy), but in order to be able to control its (would-be) expansionist successor.⁶ In this two-period game, the equilibrium level of public spending is somewhere in between the levels that the two would prefer if they remained in office in both periods. Aghion and Bolton (1990) confirmed the main findings of Persson and Svensson (1989). However, they also added that conservative-rational voters preferred the accumulation of debt because more people would be active in the debt securities markets and thus citizens would become more cautious in monitoring and sanctioning their (misbehaving) politicians. Interestingly, the "debt-tactics" of the Reagan Administration in the eighties

⁵ An important difference between the two models is that while in the case of Alesina and Tabellini (1990) the current government still has a chance to get re-elected, albeit its exact chances are uncertain, here the current government is certain that it is unable to hold onto power.

⁶ In fact, the model of Alesina and Tabellini (1990) is a symmetrical one, as both parties can use debt strategically. The Persson and Svensson (1989) model is asymmetrical in the sense that it is only the conservative cabinet which may manipulate the level of indebtedness with the aim of restricting the policy options of its successor. Moreover, it is easy to see that following the logic of Persson and Svensson (1989) one should also find that contrary to the general conviction, it is the left party which accumulates surpluses (in good times), since this is the only way to "enforce" conservatives to spend more after a change in government.

seemed to verify the point of Persson and Tabellini (1990) and Aghion and Bolton (1990). The reduction in taxes and the increase in military spending substantially constrained the room of policy choice of the Democrats in the first half of the nineties, who (would have) preferred an increase in social security expenditures.⁷

The topic of strategic behavior has been analyzed quite often in relation to the issue of political instability. The strategic use of debt may result in a situation in which the newly elected government (the successor) cannot adhere to its electoral promises; therefore, its popularity deteriorates quickly. The consequences are twofold: a permanent state of uncertainty and short-lived cabinets. Nevertheless, too frequent changes in power can erode the virtues of democratic regimes, giving birth to dissatisfaction and political chaos.

The fact that strategic behavior seems to be a systemic element of democratic regimes compelled Alesina and Tabellini (1990) to demand binding rules in order to limit the incentives for overspending. Apart from the usual idea of a balanced budget rule with certain contingencies in case of unseen events, the authors refrained from giving a concrete guide to limiting politicians' arbitrariness, but they clearly support "the view that each government should not have complete discretion in its choice of how much deficit to leave to its successors" (*ibid.* 413).

Although the models with debt as a strategic variable contributed to the understanding of the new fiscal phenomenon from the first half of the seventies onwards, they have a limited explanatory power, as they consider a closed economy only. The model does not provide any solution for those cases where the future government is not constrained by public debt when it defaults.⁸ Moreover, neither the Alesina–Tabellini model nor the Persson–Svensson model examine the case where the level of public debt directly influences the electoral results and, thus, a new strategic opportunity emerges for the political actors to increase the possibility of their

⁷ Indeed, Bill Clinton left his office in 2000 with a huge surplus in the public budget, and the successor conservatives under Bush—copying the example of Reagan—accumulated a huge deficit and debt. Interestingly, the last 25 years in the USA seem to verify the point that conservatives behave as fiscally non-conservatives, while Democrats are more or less fiscally prudent.

⁸ By reflecting upon the experiences of Latin-America in the eighties, Alesina and Tabellini (1989) developed an open-economy model in which they established a connection between indebtedness and political instability. In their view, the current governments were limited in issuing debt, which was caused by the default risk (introduced as an output loss).

re-election (see especially Milesi-Ferretti 1995, and Milesi-Ferretti and Spolaore 1994).

3 Public debt as a non-strategic variable in CEE

By and large, public debt might have indeed played a crucial role in constraining fiscal space between alternating governments in several CEE countries. However, this was hardly the case in each of the ten new countries which joined the EU in 2004 and 2007. For instance, the Baltic states were in a unique position, since the three countries inherited quite small debt stocks from the communist era. Estonia went through a severe transformational recession between 1991 and 1994, which was followed by a relatively fast recovery.⁹ The first democratically elected Pro Patria National Coalition managed to initiate major structural reforms, such as price liberalization, monetary reform, and privatization, relatively early on from 1992 onwards. Although the 1995 elections saw a change in the composition of the ruling cabinet, the implementation of reforms (especially the establishment of a currency board, price deregulation, property rights reform, enterprise reform, and trade liberalization) did not stop under the Coalition Party and the Rural Union. In fact, Estonia experienced a strong economic take-off from 1995 onwards, which was curbed only by the Russian financial crisis in 1998 (OECD 2011). Fiscal discipline was maintained until the end of the period under scrutiny by the centrist and social liberal Estonian Centre Party (1999 to 2007), too (see Figure 3.1).¹⁰

Just like Estonia, Latvia and Lithuania started economic transformation with a relatively low level of debt. In Latvia, there were three occasions when the debt level increased, but none of these episodes reflected fiscal laxity or political bias. In 1999, the debt-to-GDP ratio increased due to the Russian crisis; whereas in 2001 and 2003–04 the increase was the consequence of strong cyclical effects (see Table 3.1). Both the People's Party-dominated coalition governments (1998–2002, 2006–10) and the New Era Party-led coalition (2002–04) were successful in maintaining a stable fiscal position during the years of analysis.

⁹ The change in the Estonian GDP was -12.6, -14.2, -8.6, and -3.2 percent in 1991, 1992, 1993, and 1994, respectively (Hansson 1997).

¹⁰ The Estonian Center Party became the greatest opposition party in the parliament until 2007, when it lost the elections against the Estonian Reform Party.

Table 3.1. Cyclically adjusted net lending/borrowing, excluding interest payments, 1998–2007.

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Bulgaria	6.2	n.a.	3.9	5.3	0.7	1.0	2.9	1.7	2.1	0.8
Czech Republic	-2.8	-1.5	-2.2	-4.0	-4.4	-4.8	-1.3	-2.8	-3.2	-2.3
Estonia	-0.1	-2.0	-0.2	-0.6	-0.3	0.8	0.9	0.3	0.0	-0.9
Latvia	0.6	-2.6	-1.3	-0.7	-1.6	-1.3	-1.3	-1.7	-3.1	-4.0
Lithuania	n.a.	0.4	0.3	-0.6	0.3	-0.7	-1.9	-1.7	-2.2	-3.7
Hungary	n.a.	1.7	2.1	0.3	-5.5	-3.7	-3.0	-5.0	-7.5	-2.2
Poland	-0.9	-0.1	-0.7	-2.0	-1.1	-2.2	-2.3	-1.1	-1.6	-0.9
Romania	0.5	1.7	0.8	1.1	0.9	0.1	-1.2	-1.3	-3.7	-4.7
Slovakia	-3.2	-3.6	-7.5	-1.8	-4.2	0.0	0.1	-1.0	-2.2	-2.3
Slovenia	n.a.	n.a.	-1.9	-1.8	-0.6	-0.9	-1.1	-0.6	-1.4	-1.5

Source: AMECO (2013).

Note: data as percent of the GDP.

Although the case of Estonia and Latvia seems to defy the general validity of the concept of the strategic use of debt, the third Baltic state, Lithuania, may provide some food for thought. Debt increased substantially under the leadership of the center-right Homeland Union in the second half of the nineties. Although in 1999 the Russian crisis hit all three Baltic states very hard, it cannot serve as an adequate and exclusive answer in the case of Lithuania. In 1996, in the year of the elections that resulted in the victory of the Homeland Union, the debt increased by 20 percent (11.5 percent in 1995 and 13.8 percent in 1996), and the average increase between 1997–2000 was 15.07 percent. The main reason for the acceleration of debt in the second half of the nineties was probably due to Lithuania's transformation strategy. According to Bertelsmann Stiftung (2012), politicians attempted to avoid the huge social costs of transformation; thus, they embarked on deficit financing. In fact, a comprehensive reform process started only after the beginning of the new millennium. According to Zápál and Schneider (2006), from 2001 onwards, the country started to reduce its debt-to-GDP ratio and managed to keep fiscal targets in spite of huge increases in health and pension expenditures (see Figure 3.1).

As a corollary, debt did not seem to play a systematic role as strategic variable in the Baltics. Two alternative hypotheses can be formulated to rationalize this behavior. First, Estonia, Latvia, and Lithuania—as former member states of the communist empire, the Soviet Union—, wanted to

break away and to re-orientate themselves as quickly as possible. Therefore, political elites actively supported a quick economic recovery and a fast catch-up to the West in order to ensure their countries reintegration into Europe. Alternatively, it can also be claimed that although the country avoided debt accumulation in the public sector, it allowed its private actors to engage in a dramatic consumption increase and private debt accumulation—a phenomenon described by Csaba (2008) as “macroeconomic populism” (which is discussed in detail in Chapter 5 of the present volume).

Besides the Baltics, Slovenia has often been regarded as one of the fiscally most disciplined countries among the new member states (Zápal and Schneider 2006). Although the level of the general government gross debt did not even reach the half of the 60 percent Maastricht reference value, the debt-to-GDP ratio did indeed display a moderate but steady increase in the first ten years of the independent state, until 2002. During this period, the Liberal Democracy of Slovenia (LDS) dominated the political arena.¹¹ As EU accession became a reality, the governing forces agreed on pursuing a strict fiscal policy in 2002 in order to fulfil the Maastricht convergence criteria. In spite of the successful EU accession and the effective consolidation efforts which managed to maintain economic growth, the LDS was voted out of power and the conservative Social Democratic Party formed government in 2004. The new cabinet did not seem to use public debt strategically either in the next couple of years. In fact, following the EU accession the country targeted Eurozone membership and was able to enter the zone in 2007.

While the Baltic states and Slovenia entered their postcommunist era with a relatively low level of debt, this was hardly the case with Bulgaria. By 1997, the debt-to-GDP ratio was 105.1 percent, the highest in the whole region under scrutiny. The most important factor in the build-up was the transition crisis¹² and the 1996 banking crisis, accompanied by hyperinflation. The immediate cause of the banking crisis was a liquidity injection to commercial banks and the intervention of the central bank

¹¹ The party won the greatest share of the votes in three consecutive elections, i.e., in 1992 (23.5%), 1996 (27%), and 2000 (36.2%). Parliamentary elections data are taken from the European Election Database (2013).

¹² Bulgaria suffered a roughly one-quarter drop of its GDP by 1993. After that, however, a slow increase in economic activity started, which suddenly halted in 1995, and the country faced another 10 percentage point decline in its GDP (Fischer and Sahay 2000).

to finance the budget deficit (Gulde 1999).¹³ 1997 reflected, however, a major turning point in the postcommunist history of Bulgaria. The winning coalition, the Alliance of Democratic Forces had basically no other choice than to commit themselves to a severe consolidation program built on the advice of the IMF. The government adopted a currency board and reduced the real value of the domestic debt, which had initially been very favorable in maintaining a balanced budget (the general government deficit was 8.0 and 11.2 percent in 1995 and 1996, respectively) due to interest payments.

The reform of public finances was so successful that the debt-to-GDP ratio was reduced to less than the Maastricht reference value by 2002 and dropped below 20 percent (!) in 2007 (see Figure 3.1). Interestingly, the effective monetary and fiscal consolidation was not reversed even at the time of the Russian crisis. By now, it can be safely claimed that Bulgaria belongs to that group of the CEE-10 countries where there has been a strong reform commitment and fiscal discipline during the studied period. Absolutely no sign of using public debt could be detected during the analyzed period. Nevertheless, it is worth mentioning that this was the only option for Bulgaria to join the European Union and not to lag behind the other new member states.

4 Debt as a strategic variable

Whereas the former five countries did not seem to use public debt strategically, the other CEE economies, especially Hungary and Poland, embarked on such activities—for different reasons and to various degrees. In the following, therefore, the debt performance of the rest of CEE countries will be scrutinized.

Generally speaking, the transformation of the Hungarian economy was a success story in several respects. However, it was heavily burdened with alarming features as well, especially the large (external and internal) indebtedness, which the first freely elected conservative coalition was not able and not willing to tackle at all. In fact, due to the advances in market reform, Hungary postponed the necessary structural reforms of public

¹³ The controversy measures were adopted by a left-wing coalition (its members were the Bulgarian Socialist Party, the Bulgarian National Agrarian Union, and the Ecoglasnost Political Club).

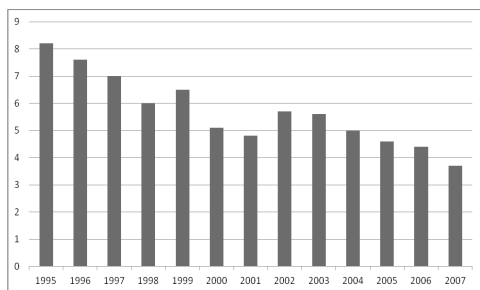


Figure 1a. Estonia (1995–2007).

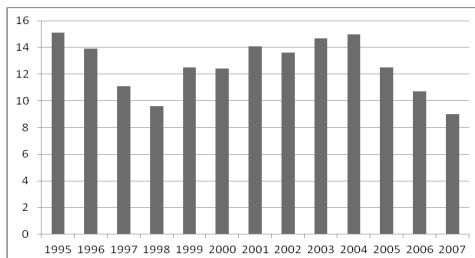


Figure 1b. Latvia (1995–2007).

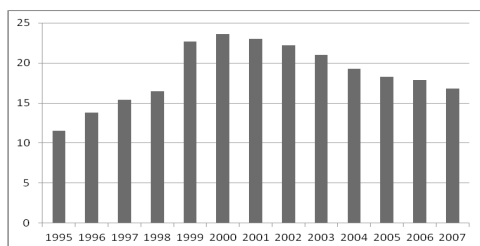


Figure 1c. Lithuania (1995–2007).

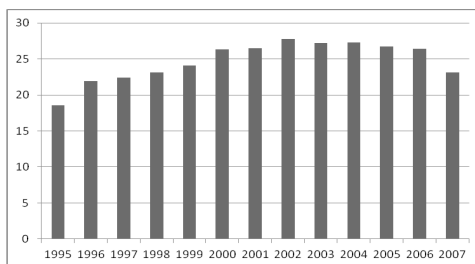


Figure 1d. Slovenia (1995–2007).

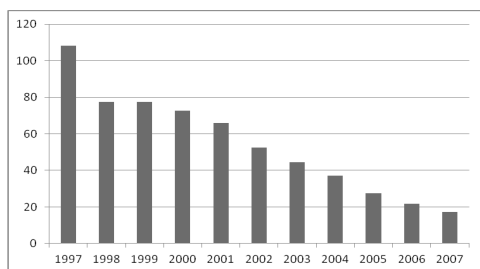


Figure 1e. Bulgaria (1997–2007).

Source: Eurostat (2013).

finances until the escalation of the macroeconomic instability in 1994–95. The right-wing coalition thus maneuvered the new incoming socialist-liberal government into a situation where the Hungarian Socialist Party and the Alliance of Free Democrats had simply no other chance than to embark on a severe austerity program in order to prevent Hungary from becoming the next Mexico in 1995.¹⁴ The austerity package was adopted in March 1995, and in consequence primary expenditures were reduced from almost 52 percent to 41.6 percent of the GDP in just one year. Primary revenues fell somewhat also but to a much smaller extent than expenditures, which helped to improve both the primary and the general balance OECD (1999a). As Figure 3.2 shows, public debt was above 80 percent in 1995, but four years later it was brought down to the Maastricht reference value of 60 percent, mostly financed from privatization proceeds. The budget deficit was also reduced mainly by cutting back household transfers and the public sector wage bill.

Despite the strong economic recovery, the socialist-liberal coalition lost the next elections in 1998, giving an opportunity to the right-wing forces to consolidate the reform.¹⁵ The leading coalition party, Fidesz, however, tried to distance itself from the socialist-liberal government's legacy of austerity and reform and declared itself as the party which aimed at increasing the standard of living, targeting especially its voter base, the middle class. Nevertheless, during the first two years in power, the Fidesz-led cabinet did not threaten fiscal stability. The economy showed a robust growth in any comparison, which provided enough room for the government to achieve its objectives without undermining fiscal sustainability. Yet, the stable internal and external conditions and the strong economic growth would have made it possible for the right-wing coalition in the first two years to go ahead with the still awaited structural reforms, especially in the sphere of education, health care and public administration.

¹⁴ The Hungarian Socialist Party (HSP) won 54 percent of the total seats in the parliament, while the Alliance of Free Democrats (AFD) received 18 percent of the seats. The incoming new coalition government, comprised of the HSP and the AFD, was not willing at first to admit that without a radical change, Hungary was heading towards a catastrophe. Instead of using its two-third majority in the parliament to embark on a firm set of actions in order to regain credibility and restore equilibria in external and internal positions, the coalition attempted to create wide-scale social agreements which, however, were never realized.

¹⁵ After the May 1998 elections, Fidesz formed a new government with the Hungarian Democratic Forum and the Independent Smallholders' Party. The coalition had a 54 percent majority in the parliament.

The run-up to the 2002 elections, however, dramatically accelerated public spending. While Fidesz and its allies were almost sure until the end of 2001 that the forthcoming election would be won by the right-wing forces, the trend changed at the very beginning of 2002—just three months before the general elections. The incumbent parties had to react quickly in order to change the unpleasant trends and embarked once again on generous spending programs and promises. This time the main elements of the increased spending included a public sector and a minimum wage rise and an increase in household transfers—targeting voters directly.¹⁶ The government also accelerated motorway construction and provided extra funds for small- and medium-sized enterprises.

The election campaign of April 2002 saw the victory of the Hungarian Socialist Party, though only with a slight majority. The HSP formed a new cabinet along with the Alliance of Free Democrats. Although it was evident that the economy had already veered onto the road of sustainable economic development, the unusually narrow majority, the oppressive political atmosphere (as for instance the questioning of the election results), and the load of election campaign promises made it politically difficult for the new incumbents to embark on fiscal adjustments. As a result, the long-awaited reforms were postponed, and the government engaged instead in an extraordinary acceleration of public spending. They initiated substantial increases in the public sector salaries, family allowances and housing subsidies.

By the end of 2005, just a couple of months before the next general elections, according to Antal (2005), the direct threats of a crisis did not (yet) emerge in the economy – as opposed to the year of 1995 –, however, there was an immense lack of political commitment concerning adjustment and reform. Budget deficit climbed up to 9.2 percent in 2006. The outstandingly huge public deficit, however, cannot be considered as strategic in the sense of Alesina and Tabellini's (1990) use of the term. Instead, it reflected the typical political business cycle characteristics of the Nordhaus (1975) model. Ferenc Gyurcsány, the president of the HSP and then prime minister, wanted to lead his party to victory at the 2006 general elections, which, in fact, did see the victory of the governing socialist-liberal coalition. This was the first time in the country's postcommunist history that

¹⁶ For instance, pension payments were raised by 9.7 percent. The government prepared a new proposal by which taxpayers would have been allowed to transfer part of their income tax to their retired parents. Additionally, an interest-free loan was made available for farmers (EIU 2002b:17).

incumbents were able to prolong their mandate for another four-year cycle. The price, however, what both the incumbents and the country itself had to pay for the 2006 victory was incredibly huge. In a supposedly confidential speech that was, nevertheless, recorded and released to the public in September 2006, Mr Gyurcsány admitted that the HSP-AFD coalition did not do anything between 2004 and 2006 in order to stabilize the economy. He also admitted that his government was constantly lying to the public on the real conditions of the Hungarian economy with the aim of securing the coalition's victory at the 2006 elections.

Similarly to Hungary, Poland started the process of transformation with a huge debt, which seriously constrained the policy space of alternating governments. Although Poland managed to reduce its debt level already in the nineties, when most of the countries struggled with the negative consequences of transformational recession, its success was mostly due to the successful combination of accelerated economic growth, appreciation of the real exchange rate and external debt relief; that is, no real efforts were made in order to initiate a comprehensive reform of the general government (OECD 1998b). Although no deliberate actions were enacted to strengthen fiscal discipline until the second half of the nineties, the ruling left-wing coalition (Alliance of the Democratic Left, 1993–97) adopted a new constitution, which made a debt brake effective in Poland.¹⁷

The real turn, however, arrived in late 1997, when the Solidarity Electoral Action formed a coalition with the market-oriented Freedom Union. The new right-wing cabinet put an immediate stop on the further increase of public sector wage bill, which showed an unprecedented acceleration during the previous cabinet in 1996 and 1997. The new incumbents also decided to halt the further escalation of pension expenditures by initiating wide-scale structural reforms in the sector from 1999 onwards. Structural reforms also targeted public administration and social welfare programs. As a consequence of the restrictive approach of the new coali-

¹⁷ A public debt ceiling was set by the constitution at 60 percent of the GDP and the president was deprived of the power to veto the budget. Furthermore, direct central bank lending to the general government was prohibited from 1998, and the Monetary Policy Council, chaired by the governor of the National Bank of Poland and nine other members, was set up in order to ensure the independence of monetary policy. The supervision of banks was also strengthened. The new rules showed the streamlining efforts of the countries with the European standards; however, the 60 percent debt ceiling provided a comfortably large playground for fiscal maneuvers (Rutkowski 2007).

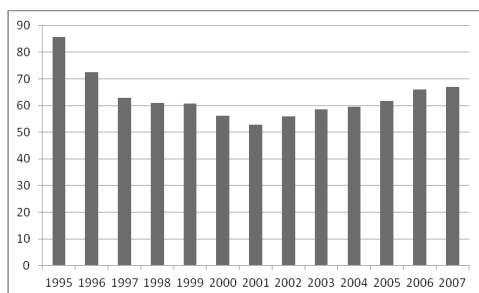


Figure 2a. Hungary (1995–2007).

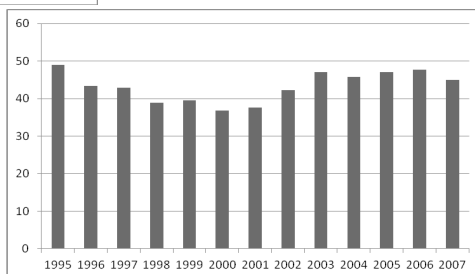


Figure 2b. Poland (1995–2007).

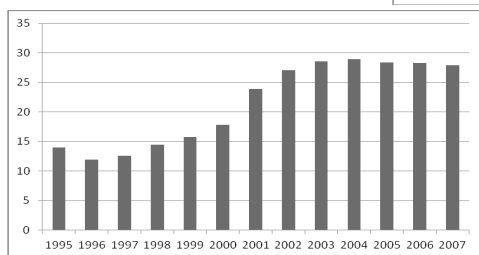


Figure 2c. Czech Republic (1995–2007).

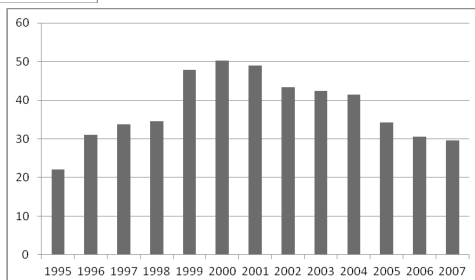


Figure 2d. Slovakia (1995–2007).

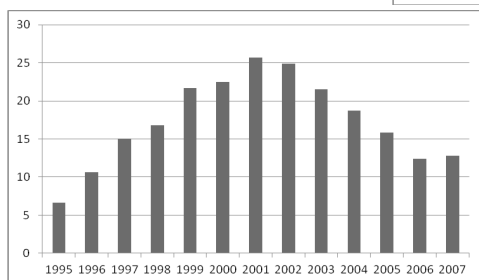


Figure 2e. Romania (1995–2007).

Source: Eurostat (2013).

Figure 3.2.
Public debt in selected
CEE countries
(% of GDP).

tion, both deficit and debt started to decline between 1997 and 1999 (on public debt, see Figure 3.2). Albeit the downward trend of the debt and budget deficit was moderated somewhat by an economic slowdown in 1998 and 1999 (OECD 2008), the tendency remained clear. The decline stopped only in the year of the following parliamentary elections, bringing the victory of the opposition forces, i.e., the Alliance of the Democratic Left–Labor Union (ADL-LU), which gained 41 percent of the votes. Citizens punished the governing coalition for two major reasons: reduction in public welfare transfers and programs, and corruption scandals.

During the term of office of the Alliance of the Democratic Left–Labor Union (2001 to 2005), the debt level substantially increased (from a starting level of 37.6 percent of the GDP in 2001 to 47.1 percent by 2005—see OECD 2008). The increase was more visible in the election year of 2005, which was preceded by a moderate fall of the debt level in 2004 as a result of a robust economic growth. Importantly, the cyclically adjusted deficit data (see Table 3.1) also confirms that fiscal laxity prevailed in the country between 2001 and 2005. In sum, the permanent increase in the deficit and thus the repeated budgetary overruns which continued under the return of the center-left coalition from 2001 resulted in the increasing indebtedness of the country (OECD 2004b).

One of the main reasons for the absence of fiscal discipline during the first half of the 2000s was the sharp political tensions between the coalition parties. The ADL-LU and the Polish Labor Party (PLP) were not able to reach a compromise on several policy issues, which led to the exclusion of the PLP from the government in 2003. The minority government, however, did not prove to be more effective either, and its popularity deteriorated relatively soon. In consequence, the ADL lost the next general elections of 2005 by only 11.31 percent of the votes. The Law and Justice Party managed to form a minority government led by Prime Minister Kazimierz Marcinkiewicz. In the following years, not only the annual budget deficit, but also the cyclically adjusted balance and the debt-to-GDP ratio showed a declined trend.

Thus, the left-wing coalition governments (i.e., between 1993 and 1997 and during 2001 and 2005) showed a significant political bias towards fiscal indiscipline, accumulating deficit and debt—although during their first government cycle the strong economic performance of the country hid this feature away. Although the right-wing government managed to introduce strong legal insurances for the elimination of deficit bias and debt increase, it could not prevent the left from engaging in debt increase, since even after the constitutional limits, a substantial room for laxity was provided for the new incoming forces.

If Poland was the example of intense conflicts and frequent changes in government, the Czech Republic can be regarded as the other extreme with relative political calm and stability. More importantly, as opposed to most of the CEE countries, the Czech Republic experienced a strong economic growth right after the systemic change, mostly due to the devaluation of the Czech national currency, the koruna, by nearly 50 percent. Practically it meant that the Czechs were reluctant to initiate the necessary structural reforms which could have put the country on a sustainable track of economic development. Consequently, real wages increased and inflation started to accelerate, too. As the export performance deteriorated and was not followed by a decline in domestic demand, the current account displayed huge deficits and placed the exchange rate under serious pressure. The deteriorating trends culminated in a currency crisis in 1997 which, in turn, triggered a severe slowdown of economic activity (OECD 1998a).

The 1996 parliamentary elections proved to be unique in the CEE region: the unwillingness of the right-wing cabinet to engage in comprehensive and painful stabilization measures—along with lax fiscal policy which resulted in an unavoidable widening of the deficit in the structural balance between 1994 and 1996 (Burns and Yoo 2002b)—ensured that the Civic Democratic Party remained in power, albeit it was a fragile minority coalition only.

The currency crisis of 1997,¹⁸ coupled with financial scandals concerning the activity of the incumbents, led to early elections in 1998. The elections brought the victory of the Czech Social Democratic Party (CSDP), which repeated its success in the next elections as well (in 2002). The change in government, however, did not mean a turn towards fiscal discipline. The debt-to-GDP ratio continued to climb until 2004. The balance of the general government substantially deteriorated in 2000 and 2001 as a consequence of discretionary fiscal decisions (Burns and Yoo 2002b), which, however, kept the governing party in power in 2002.

¹⁸ The exchange rate crisis in 1997 caused a further slowdown of economic activity (OECD 1998a). During this period, the level of the general government deficit mirrored the cyclical trends, reaching 3.6 percent of the GDP. The stabilization package, introduced by the conservative coalition, and which included a private sector wage freeze, however, failed to be sustainable, as the growing deficit was partially the consequence of structural imbalances. Although the budget deterioration during the 1990s reflected pro-cyclical movement, the rapid deterioration in 2000 and 2001 was mainly the consequence of discretionary fiscal decisions made by the governing parties.

A closer look at the main fiscal aggregates can reveal that the ratio of public spending was stabilized on a near-constant level between 1993 and 1999, but suddenly rose to 48.4 percent of the GDP in 2000. Revenues also increased, but at a much slower pace. Within the general budget, the share of the mandatory expenditures (social transfers, health insurance and debt service payments) and the quasi mandatory items (military spending and wage expenses in public administration) reached nearly 80 percent of total spending in 2002–03 (OECD 2003). All these measures reflected the CSDP's intention to keep its lead position in the political arena.¹⁹

It was only in 2003, that is, one year after their second victory, when the coalition government introduced a fiscal and public expenditure reform. The fiscal deficit started to decline after its peak in 2003 (6.7 of the GDP) and dropped to 2.8 percent in 2004. The first reform package contained both tax- and expenditure-related measures. The second round targeted the structural reform of the pension and health care system (OECD 2004a). Although right before the elections of 2006 government expenditures were on the rise once again (see the cyclically adjusted data in Table 3.1), which secured the repetition of the previous election results (the CSDP gained 32.3 percent of the votes), the center-right Civic Democratic Party (led by Mirek Topolánek) outperformed the CSDP with 35.38 percent of the votes and could form a new coalition accordingly.

All in all, the Czech political and fiscal performance reflected a rather strange situation in the period under scrutiny. No real measures were taken during the first term of the Civic Democratic Party (between 1992 and 1996), which prevented the country from facing a serious transition recession; however, the country could not avoid a crisis in 1997, which made it overt that without structural reforms even such a relatively developed country could not survive for long. Sadly enough, the new incoming (leftist) parties did not learn much from past mistakes and did not embark on wide-scale reforms right after the crisis, either. The CSDP was reluctant to commit itself to fiscal discipline between 1998 and 2002. It was only due to external pressure from the approaching EU accession that induced the governing socialist coalition to change its previous mentality and to launch a comprehensive reform program.

¹⁹ The CSSD received 32.3 percent of the total votes in 1998. In 2002, there was a slight deterioration, when it gained only 30.2 percent of the votes (European Election Database 2013).

Accession to the European Union was a (pre-)condition for successful reforms not only in the Czech Republic but also in Slovakia. Similarly to the Czech Republic, Slovakia was also characterized by intensive GDP growth and a relatively low inflation until 1997, which made the country one of the most successful transition economies by the mid-nineties. According to the OECD (1996), the sound and credible monetary policy, the prudent and disciplined fiscal programs, and the relative openness of the country provided a solid ground for robust economic performance. Nevertheless, there were severe macroeconomic imbalances beneath the surface, which drove up fiscal deficit and debt from 1996 onwards. The problem started with the deceleration of export, which culminated in a massive 9.9 percent deficit in the current account by 1996 (OECD 1999b). The governing coalition of the Movement for a Democratic Slovakia (MDS) and the nationalist-populist Slovak Nationalist Party (SNP) tried to lower the deficit by tightening monetary policy, which in turn caused a credit constraint on the private sector and made the financing of the state budget more challenging. As the interest burdens increased, the debt-to-GDP ratio surged as well. Although there were other import-constraining measures implemented by Mečiar's coalition government, the current account deficit remained high, close to 10 percent of the GDP. The Czech currency crisis triggered a strong speculation on the Slovak koruna, too, which made further monetary tightening necessary and put an extra cost on financing the budget deficit.

With the coming of the 1998 general elections, the budget deficit (especially the deficit of the central government) reached 5.3 percent. The overrun was the result of the compensation of public sector employees (13 percent increase) and the state's contribution to other state funds was doubled.

Although election economics worked well for the Mečiar-led MDS, which won the 1998 elections, it was the Slovak Democratic Coalition (a five-party coalition government also referred to as the "Rainbow Coalition")²⁰ which managed to form a new cabinet under the leadership

²⁰ The pro-Western opposition forces, the so-called "Rainbow Coalition" led by Mikuláš Dzurinda, comprised the Slovak Democratic Coalition, the Party of the Democratic Left, the Party of Civil Understanding, and the Party of the Hungarian Coalition. Dzurinda had the opportunity to form his second government after the 2002 elections. The new coalition partners were the parties of the center-right, namely the Slovak Democratic and Christian Union, the Christian Democratic Movement, the New Citizens Alliance, and the Party of the Hungarian Coalition.

of Mikuláš Dzurinda. The new cabinet did not hesitate to engage itself in a comprehensive reform of the economy by mid-December 1998. The new coalition decided to cut the general government deficit to 2 percent in the space of a single year, by downsizing public infrastructure projects, freezing the public sector wage bill and increasing taxes. Despite the macroeconomic stabilization steps and substantial progress in structural reforms, the general government still required further consolidation in the new millennium. Ultimately, the increasing trend of indebtedness was turned back and the debt-to-GDP ratio started to decline in 2001 (OECD 2002). Following the parliamentary elections of 2002, the re-elected Dzurinda government continued with a comprehensive reform of the tax system, the labor market, the pension system, the health care system, the state administration, and the education system (OECD 2005). As a result, the debt-to-GDP ratio declined from 50.5 percent in 2000 to 30.5 percent in 2006 (see Figure 3.2).

In sum, under the leadership of the MDS (1992–94 and 1994–98), the debt ratio increased substantially and this was not driven purely by cyclical trends but by discretionary and politically motivated actions. By 1998 it became clear that the country, led by the Mečiar cabinet, eroded its chances of joining the European Community.²¹ If the country wanted to join in the first wave of CEE countries, it had to embark on a series of economic and political reforms, which entailed social costs. The new right-wing cabinet, therefore, did not have any other option but to commit itself to severe reforms, which might have indeed erode its popularity. Lamenting on the strategic behavior of the Mečiar government, it is reasonable to assume that it was not the public debt *per se* what Mečiar used strategically, but EU accession. Since Mečiar and his party firmly opposed EU accession, they tried to make the accession to the EU as expensive for the new incumbents as possible.

Among the European transition countries, Romania had some of the worst starting conditions, except for the inherited debt-to-GDP ratio (IMF 2004). Despite the huge poverty in the country, the former communist party first secretary, Nicolae Ceaușescu, enforced Romania to engage in a dramatic debt-repayment program in the eighties. It gave freely elected governments ample room for fiscal laxity following the systemic change.

²¹ Nevertheless, the party's social support showed stability throughout the years. In 1992 the party received 37 percent of the votes, while two years later, the HZDS and the RSS gained 34.9 percent.

As a corollary, the debt-to-GDP ratio dynamically rose from 1995 onwards from its starting level of 6.6 percent (in 1995). The first wave of increase was mostly due to the 1996 elections. The Democratic National Salvation Front (elected into office for the first time in 1992) practiced lax fiscal policy before the 1996 parliamentary elections and the debt-to-GDP ratio climbed above 10 percent in just one year. Nevertheless, it still did not follow that the fiscal space of the next government (the coalition of the Democratic Convention of Romania, the Democratic Party, and the Democratic Union of Hungarians in Romania) could have been restricted substantially. Yet, the new government faced a huge inflationary pressure, which was caused by the loosened macroeconomic policy of 1995 and 1996. The coalition, therefore, had to respond to negative tendencies by introducing administrative price controls and exchange rate controls and by returning to the further liberalization of the economy. As far as fiscal policy is concerned, the coalition initiated adjustments mainly on the revenue side of the budget between 1997 and 1998—without too much success, however. The general elections of 2000 triggered a further round of fiscal laxity instead, and gross public debt climbed to 22.5 percent (IMF 2004).

It was only the incoming left-wing coalition which decided to seriously alter the previous regime of fiscal laxity and tried to stop the accelerating tendency of indebtedness. The new, reform-oriented government led by the Social Democracy Party of Romania implemented a value-added tax and profit tax reform and started to improve the revenue administration as well from 2002. Moreover, in 2003, seventy-nine proposed amendments to the constitution were approved in order to create an EU-conform state. The coalition engaged in the much awaited structural and macroeconomic reforms as well. Consequently, the upward tendency of debt was not only stopped but also curbed. Just like in Slovakia, fiscal and economic reforms were adopted mostly by necessity by the governing coalition, which was strongly committed to EU accession. The possible reward of becoming an EU member kept Romania on track even after the 2004 general elections, which placed the National Union into power.

Yet, there was a loosening in fiscal policy under the new government. The level of budget deficit doubled in three years and reached 2.9 percent of the GDP in 2007, as opposed to 1.2 percent in 2004. The cyclically adjusted deficit of the general government reflected an even worse tendency, as the cyclically adjusted deficit without interest payments reached 4.6 percent in 2007, in the year of the EU accession (Ecostat 2013). That is, fiscal consolidation implemented under the former coalition ensured the proper fiscal playground for the National Union.

5 Conclusion

One of the most significant (if not the most significant) analytical values of the classic model of Alesina and Tabellini (1990) was that it defied the general assumption regarding the motivation of incumbent political actors (such as parties) for making political-strategic decisions. They showed that myopia in itself is hardly the main explanation for persistent deficit and debt. Instead, public debt can be used strategically by incumbents in order to constrain the choices of future governments—even if such a strategic use of deficit and debt eventually culminated in a socially sub-optimal equilibrium.

The model of the strategic use of debt has been widely applied in the context of advanced industrialized countries, but there had been hardly any attempt to test its relevance on transition or emerging economies. This study has shown that some political parties and coalitions did in fact use public debt as a strategic variable in CEE. Whereas the Baltic states, Slovenia, and Bulgaria seemed to avoid the reliance on debt as a constraining device for future governments' actions, incumbents in the Visegrád countries accumulated debt, which then narrowed down the room for (spending) maneuver of the incoming parties. One of the major findings, however, was that countries like the Czech Republic, Slovakia, or Romania used structural reforms and especially the accession to the European Union strategically. A detailed summary of the main findings of the chapter has been collected in the Appendix.

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APPENDIX

Debt as a strategic variable in CEE countries: A summary.

Country	Timing of debt acceleration	Political orientation of incumbent(s)	Election results	Size of debt increase (in GDP)	Length of debt accumulation (in years)	External or internal effects	Debt used as strategic variable?
Czech Republic	1997–98	center-right	Civic Democratic Party-led coalition government won in 1996 (29.62%)	10.48	2	currency crisis (1997)	not
Czech Republic	1999–2004	center-left	Czech Social Democratic Party won in 1998 (32.31%); re-elected in 2002 (30.21%)	12.65	6		yes
Estonia	1999	center	Coalition Party and Rural Union (former center-right government), lost the 1999 elections; Estonian Center Party won with 23.41%	8.33	1	Russian crisis	not
Estonia	2002	center	Estonian Center Party won in 1999; re-elected in 2003 (25.4%)	18.57	1		yes
Hungary	2002	center-right	Fidesz lost elections in 2002 (41.07%)	6.07	1		yes
Hungary	2003–07	center-left	Hungarian Socialist Party won in 2002 (42.05%); re-elected in 2006 (43.21%)	3.71	5	strong cyclical effects (2003–04)	yes
Latvia	1999	center-right	People's Party-led coalition elected in 1998 (21.3%)	30.21	1	Russian crisis	not
Latvia	2001	center-right	People's Party dominated the coalition government between 1998–2002 but was not in the governing coalition from next year's elections (2002)	13.71	1	cyclical trends	not
Latvia	2003–04	center-right	New Era Party won elections in 2002 (with 23.98%) led the coalition government; lost elections against returning People's Party in 2006 with 16.48%	5.1	2	cyclical trends	not

Country	Timing of debt acceleration	Political orientation of incumbent(s)	Election results	Size of debt increase (in GDP)	Length of debt accumulation (in years)	External or internal effects	Debt used as strategic variable?
Poland	1999	center-right	Electoral Action Solidarity and Freedom Union formed coalition government in 1997 (33.8 % and 13.4 %, respectively)	1.8	1	cyclical trends (1998-99)	not
Poland	2001-03	center-left	Alliance of the Democratic Left-Labor Union won in 2001 (41.04%)	8.67	3		yes
Poland	2005-06	center-right	Law and Justice won in 2005 (26.99%)	2.17	2	strong cyclical trends (2005 and 2006)	perhaps
Romania	1996-99	center and center-right	Democratic Convention of Romania won in 1996 (30.17%)	35.82	4	incoherent macroeconomic policies	perhaps
Romania	2000-01	center-left	Social Democracy Party of Romania won in 2000 (36.61%)	8.96	2		not
Romania	2007	center-right	Justice and Truth Alliance won in 2004 (31.33%); not re-elected in 2008	3.23	1		yes
Slovakia	1996-98	center	Movement for a Democratic Slovakia (MDS)-led coalition won in 1994 (40.37%)	17.15	3	effects of internal distortions from 1997; speculative attack on the Slovak koruna	yes
Slovakia	1999-2000	broad coalition including parties with different political positions	"Rainbow coalition" won in 1999 (58.14%)	21.89	2	Russian crisis and the European economic slowdown	not
Slovenia	1996-2002	center-left	Liberal Democracy of Slovenia re-elected three times: 1992 (23.46%); 1996 (27.01%); 2000 (36.21%); 2004: lost general elections with 22.8%	5.26	7		yes

CHAPTER 4

Varieties of Capitalism and Public Finances in Central and Eastern Europe

Zsolt Szabó

1 Introduction

The Varieties of Capitalism (VoC) theory focuses on the institutional structure of capitalist economies and explains the differences between the two ideal typical variants of market economies as liberal and coordinated market economies. After the overview of the essence of VoC, its regional expansion to the former post-socialist countries, and its application to public finance issues, the theory will be used to describe the major characteristics of fiscal policy in new EU member states. As the empirical literature is quite narrow in this field, a primary empirical research will be carried out to examine the similarities between various public finance issues of the Western capitalist economies and the Eastern European countries, concentrating on four hypotheses. According to the empirical results, the two different paths of capitalist development, which seem to be similar to the evolution of Western countries, can also be identified in the group of the new European Union member states. Furthermore, there is no sign of any special Eastern European type of capitalism regarding the analysed public finance issues, such as state revenues or public expenditures.

2 Varieties of Capitalism

2.1 *The Varieties of Capitalism theory*

Hall and Soskice (2001) studied the connection of corporations with their stakeholders from the viewpoint of the firms' resources. On the whole they analyzed five dimensions: industrial relations, corporate governance,

inter-firm relations, innovations, and vocational training and education. Two variants of the capitalist model were distinguished on account of the observed differences in the aforementioned dimensions: 1) liberal market economies (LMEs), which include, for example, the United Kingdom, the USA, and Canada; and 2) coordinated market economies (CMEs), which is typically exemplified by Germany. The basic features of the models were defined by a dichotomy technique based on analytical methods and not by relying on historical methodology.

According to the VoC theory, the main characteristics of the LME countries are the following: short-term finance of corporations (i.e., capital markets); a liberalized labour market; employees with generalized skills; and a high degree of competition among the companies. On the contrary, the main features of the CME model include the long-term finance of firms (i.e., the banking finance); the important role of negotiations between employers and employees; and the relatively common practice of the education system providing specialized skills to the workers and the common R&D among firms. Countries with miscellaneous institutions (France, Italy, Spain, and Portugal) were placed by Hall and Gingerich (2001) into none of the groups; these were labelled as mixed market economies (MMEs).

One of the major elements of the conception of VoC is the strong institutional complementarity, which means that an institution is heavily influenced by the others. On the whole two different kinds of models are separated by the theory. Long-term finance in the CMEs makes cooperation among firms beside or instead of competition possible, and also enables the education of the employers to have company- or industry-specific skills. Workers with a specialized knowledge will be interested in long-term employment at one workplace instead of frequent changes between different jobs and firms; companies also need well-qualified labor. The results of these steps are frequent and intensive negotiations between employers and employees, and long-term innovations due to computability and stability. In contrast, LMEs support radical innovations because the typical form of corporate finance is short-term, which is in fact equal to the equity market, where the investors are interested in fast payback. Corporations in this structure are motivated to compete with each other; they are flexible, support the flexible labor market, and seek workers with generalized skills and knowledge. The employees are also more flexible and due to their general skills move more easily in the labor market.

One consequence of the complementarities is institutional path dependence, and the reason of change in the types of institutions is explained by the connections among the institutions. There are two options according to

the assumption of complementarities: either there is harmony in a country among the different institutions (capital market, labour market, industrial relations, etc.)—for example, in the form of a liberalized capital market, a flexible labor market, and loose inter-firm connections on the one hand, and banking finance of the corporate sector, negotiated industrial relations, and long-term supplier relations on the other hand, which are the characteristics of the ideal typical variants of capitalism, the USA and Germany, respectively. If a country has mixed institutions and there is not such a degree of synchrony among the institutions, then the institutions move toward either the liberal or the coordinated variety of capitalism. This movement has been referred to as dual convergence by Hay (2004). The modifications caused by the changes lead to the strengthening of the other institutions.

New institutions have been added to the original five used by Hall and Soskice (2001) as a result of the growing literature of VoC theory. These institutions have been formulated also through antagonism; they have been added to the institutional framework of LME and CME respectively in such a way that the rule of complementarities has been respected. For example, Estevez-Abe et al. (2001), Amable (2003), and Farkas (2011) added the social system, Kuokštis (2011) integrated industry policy and macroeconomic policy, Jackson and Miyajima (2007) matched the mergers and acquisitions, Schwartz and Seabrooke (2008) added the household real estate market (type of ownership and mortgage loan market), Nölke and Vliegenthart (2009) broadened it with the comparative advantages, and Iversen (2006) expanded it with political institutions. For a brief summary see Table 4.1.

Table 4.1. The main characteristics of LME and CME economies.

Feature	Liberal market economies (LMEs)	Coordinated market economies (CMEs)
allocative principle	markets	negotiation
characteristic interaction among stakeholders	spot exchange	institutionalized meeting
length of relationship	short	long
representative case	USA	Germany
financial system	domestic and international capital markets	domestic bank lending and internally generated funds
stock ownership	dispersed	blockholding

Feature	Liberal market economies (LMEs)	Coordinated market economies (CMEs)
predominant type of large firms	specialized managerial corporations, MNCs	bank controlled firms, business groups
industrial policy	limited industrial policy	important industrial and structural policy
firm relations within sectors	competitive	sectoral associations
firm relations across sectors	few	encompassing associations
mergers and acquisitions	M&A between companies having not any former connection, higher degrees of hostility	transactions are 'coordinated' through pre-existing inter-firm relationships, lower degrees of hostility
supplier relations	competitive bidding	long-term, negotiated
employment relations	short term, market	long-term, negotiated
industrial relations	few unions	strong, encompassing unions
social system	low degree of protection of employees and unemployed people	high degree of protection of employees and unemployed people
education and training system	general skills	company- or industry-specific skills, vocational training
macroeconomic regime	discretionary, centralized aggregate demand management	rules-based aggregate demand management, important role of automatic stabilizers
comparative advantages	radical innovation in technology and service sectors	incremental innovation of capital goods, manufacturing
household real estate market	high proportion of ownership	low proportion of ownership
political and electoral system	majoritarian electoral system, competition of two parties	proportional electoral system, competition of many parties

Sources: Schneider (2008:7, 10, 13, 15); Nölke and Vliegenthart (2009:680); Kuokštis (2011:9–10); Schwartz and Seabrooke (2008:244–5); Estevez-Abe et al. (2001:153); Jackson and Miyajima (2007:22); Iversen (2006:616).

Before continuing with the VoC analysis of some issues regarding the nature of the public finance of the Central Eastern European countries and Western economies, two questions have to be discussed. Firstly, how the subject of public finance and varieties of capitalism can be combined, and secondly, how the regional focus of VoC with the post-socialist countries can be broadened.

2.2 Varieties of Capitalism and public finance—theoretical issues

The original model of the varieties of capitalism formulated by Hall and Soskice (2001) did not include the issue of public finance for the reason that VoC has concentrated mainly on corporations and has neglected the role of the state. However, there are some aspects of VoC on public finance which originate in the production system. The topic of the connection between VoC and public finance can be discussed with the help of three structures: the electoral system, the welfare system and industrial relations.

The typical variant of the voting system in the LME model is the majoritarian electoral system, which fits well with the intensive competition characterized by LME, as argued by Iversen (2006). As a result, there is a two-party political system in these countries. On the contrary, the CME model is characterized by a proportional electoral system, which supports the appearance of different interests and results in a multi-party system and coalition governments. According to Ahrens et al. (2001), the aggregation of different political interests in the CME-type of capitalism leads to a bigger state, while the atomized lobbies in LMEs are hardly able to fight out additional public expenditures, and the size of the state remains small. Amable and Azizi (2011) show that theoretically in the LME countries governments intend to use discretionary tax measures more easily, as the economic policy is not blocked by interest groups, as the latter are fragmented. However, in CMEs the goals of interest groups are articulated and manifested in the coalition governments and these interests receive support from the coalition parties in order to hold the coalition governments together. This structure can easily lead to an increase in public expenditure and budget deficit. Sooner or later different kinds of automatic tools which are able to block the usage of discretionary expenditures (e.g., deficit rules, limit rules of state debt, fiscal councils, etc.) are usually introduced and used to control such an intention.

The second structure is related to welfare expenditures, since VoC does pay attention to the connection between the production system and the social protection system (Estevez-Abe et al. 2001). Accordingly, the CME model is characterized by extensive and widespread welfare expenditures in order to provide social protection to the employees to collect company- or industry-specific skills in the education and training system, which are more difficult to change later on. This kind of government policy requires a more costly education system, an extensive unemployment policy, and developed public health care. Moreover, it is also sup-

ported by the corporate sector in spite of the increased tax burden, since this is the guarantee for having enough well-trained and qualified employees. However, corporations in the LMEs need workers with general skills who can be easily and flexibly trained for their business purpose, and firms do not support an increase in taxes because they do not want to pay extra money to have more qualified employees with inflexible knowledge and high salary needs. The employees are interested in both a low tax burden and small-size states, since their convertible skills help them against the volatile movements of the labor market.

Regarding the wage negotiations in industrial relations in the CMEs, trade unions try to raise wages and salaries substantially, since they are heavily supported by the employees. However, in the CMEs the governments may introduce rules to stop the rising demand of the employees and the subsequent jump in public expenditures. In LMEs the dispersed trade unions have less influence on wages; therefore, there are usually no automatic rules in fiscal policy, which can lead to the more frequent usage of discretionary fiscal policy steps. Although monetary policy is not in the focus of the analysis, it must be mentioned that a similar difference can be observed in monetary policy between LMEs and CMEs (Soskice 2007; Amable and Azizi 2011).

2.3 Varieties of Capitalism and the Central Eastern European countries

Economic theorizing on CEE countries had been ruled by transition problem issues right up until the rapid development of VoC after the millennium and its consequent application to post-socialist countries. However, basic elements of the later models such as LMEs, CMEs, and others also became visible in the region quite early, after the collapse of the bipolar world (Martin 2008).

The antecedents of liberal market economy occurred as a result of the direct or indirect effect of the appearance of international organizations and institutions in the region. At the beginning of the Eastern European transition, the reforms, which were suggested by international organizations, such as the European Bank for Reconstruction and Development (EBRD) and the World Bank, were in accordance with the LME models. The direction of the suggested reforms, which were manifested in the so-called Washington consensus (Csaba 1995), were characterized by the narrow-minded view of capitalism of these organizations. However, the creation of LME models in Eastern Europe was made difficult by the fact that the capitalist development in the post-socialist countries was not even

in the different fields of the market and economy, e.g., the liberalization process was faster in product markets and capital markets, the economic role of the state remained important, and development was also influenced by the legacy of former socialist institutions (Newman 2000). In spite of this fact the development paths of the three small Baltic states after the collapse of the Soviet Union have been close to liberal market economies (see for example Buchen 2005; Bohle and Greskovits 2007; Feldmann 2009; Adam et al. 2009).

The building of a German-style capitalism or the introduction of the coordinated market economy model in CEE countries, especially in economies close to the German borders, was supported by political, moral, and ideological methods from Berlin and Vienna. However, the strengthening of such model succeeded only in special circumstances. The checks and balances, which help the survival of this model, developed first of all in Slovenia, which has been characterized by the relatively small size of the country, the quite developed structure of the economy at the beginning of the 1990s, and the Slovenian society's ability and demand to make compromises. However, this model has suffered an increasing number of damages by accelerating globalization (Feldmann 2009; Bohle and Greskovits 2007; Martin 2008; Adam et al. 2009).

The typology of the Eastern European economies using VoC categories is not unified. They are categorized in some studies as CMEs (e.g., McMenamin 2004), and as LMEs in others (e.g., Hoffmann 2004). There are analyses of course which regard these countries as a heterogeneous group, where there are both CMEs and LMEs (e.g., Bohle and Greskovits 2007), while others consider some of these economies as a subgroup within the capitalist model (e.g., Kuokštis 2011; Papava 2006), and others label them as a new kind of capitalist variant (e.g., Nölke and Vliegenthart 2009; Farkas 2011). In sum, it can be concluded that the more complex the researches of the transition economies are, the more specialties of Eastern European countries surface.

3 Varieties of Capitalism and public finances in CEE

3.1 *Previous empirical results*

It should be first emphasized that the analysis of CEE public finances using the methods of VoC can be considered as an uncharted area; therefore, the literature review of the empirical results of the Western countries can serve as an orientation point. Studies regarding the Western

economies have basically five focus points: the research of public expenditures; the study of revenues of the budget, which together relate to the question of the size of the state; the analysis of the cyclical characteristics of expenditures; the examination of the globalization effects on the role of the state; and the research of the convergence between LMEs and CMEs in connection with the effect of the policies of the European Union.

The literature of the studies focusing on social expenditures includes the analyses of Ahrens (2011) and Hall and Gingerich (2004); however, the root of this literature originates in the work of Esping-Andersen (1990), who created the typology of welfare systems. The empirical analysis of Hall and Gingerich (2004) focused on 20 countries, which did not contain a single transition economy. The study concludes that both in the 1980s and the 1990s CMEs on average have a higher rate of social expenditures per GDP than LMEs, while MMEs occupy an interim position. Ahrens (2011) studied 126 countries in the period between 2003 and 2007, and observed that the proportion of public expenditures per GDP is higher in CMEs than in LMEs. However, he also states that this result is influenced not only from the demand side by the variant of capitalism, but also at least in the same degree from the supply side by the quality of governance, which explains why the size of the public expenditures is relatively low in some African and Asian states that have the features of CMEs.

The analysis of the state revenues is close to the first of the five focus points, as both of them are related to the study of the size of the state. In this field, Campbell (2005) made an important contribution, who studied the proportion of taxes to GDP in 18 OECD economies. His conclusion was that in 1970, 1980 and also in 1998 LME countries had a lower proportion of taxes to GDP than CME economies. An other characteristic of the LME countries is that both in 1990 and 1998 there was a higher ratio of revenues from total taxes on income and profits to state revenues than it was in CME economies, and the ratio of both the social contributions and the taxes on goods and services to the GDP ratio was lower than in CMEs.

The study of economic cycles and especially cyclical public expenditures is a widening area in the research of public finance issues and VoC, where the analysis of Amable and Azizi (2011) can be regarded as an important empirical work. Their study on 18 OECD countries in the period between 1980 and 2002 and revealed that fiscal policy is procyclical in LMEs, which means that there is a loose economic policy during booms and there is a strict budgetary policy during recessions. However, in CMEs there is a neutral fiscal policy during the periods of boom and an expansive budgetary policy during the periods of economic decline. Although

not mentioned in the study, the reason for this phenomenon is the more intensive usage of automatic fiscal stabilizers such as doles in CMEs.

VoC theory also tries to respond to a number of questions: whether globalization leads to a smaller state; whether the proportion of social expenditures to public expenditures falls in each variant of the economic model owing to the declining bearing of the state (Aiginger et al. 2007; Hall and Gingerich 2004); and whether tax rates decrease due to the fight for investors (Campbell 2005). The proportion of social expenditures to GDP increased in all of the LME, MME and CME models between the 1980s and the 1990s as well, according to the research of Hall and Gingerich (2004) focusing on 20 OECD countries, and the average changes were an increase from 15 to 19%, from 17 to 24%, and from 23 to 28%, respectively, which means that the size of the state did not decrease in any of the models as a result of the globalization. Furthermore, there was an increase in each of the models. Aiginger et al. (2007) show similar results in their study and conclude that there was a general increase in the ratio of social expenditures to GDP between 1980 and 2003 in the Scandinavian, the Anglo-Saxon, the Continental European, and the Mediterranean economies, with an average of 4.2, 3.2, 4.9, and 6.5 percentage points, respectively. Campbell (2005) concentrated on the state revenues in 18 OECD countries instead of the expenditure side of the budget, and claimed that both in the LMEs and the CMEs there were continuous increases in the total tax revenues to GDP ratios between 1970 and 1998. The categorization of the 18 economies to residual, social democratic, and Christian democratic welfare states brings similar results, i.e., there is an increase in each type of welfare state.

The studies relating to the globalization effects are supplemented to some degree by works which examine whether the deepening of the European integration leads to convergence and homogenization of national- and model-specific characteristics (e.g., Ferreiro et al. 2010; Lendvai 2009; Rhodes 2005). Rhodes (2005) stated that the CME and MME variant of economies are placed under more pressure by globalization than LMEs, as employees are urged by the generous welfare expenditures to leave the labor market, which decrease the competitiveness of these countries. However, the deficit rules accepted by the EU limits welfare expenditures; therefore, these countries are expected to redefine their economic model. Ferreiro et al. (2010) argue that the Maastricht Treaty and the Stability and Growth Pact use one-size-fits-all rules and the EU intervenes in an increasing number of economic and social issues within the member states, which on the whole turn against the bipolar view of VoC. The economic literature is

not consistent on whether there is a convergence among the member states (e.g., Sanz and Velazquez 2004; European Commission 2004), whether this convergence is limited at best, or whether the differences remain (Starke et al. 2008; Ferreiro et al. 2008). The fiscal rules of the European Union pose huge difficulties for the new member states of the EU as well, and according to the research of Lendvai (2009), the level of the public expenditures of these countries will be diverted in the direction of LMEs.

3.2 An empirical analysis with a special focus on the new EU member states

With the help of an empirical study, the following section of the chapter will analyze to what degree the theses of the VoC theory focusing on fiscal policy are justified regarding the CEE countries, and to what degree are they similar to or different from Western economies. The database of the World Bank (World Development Indicators—WDIs) and the European Commission's Directorate General for Economic and Financial Affairs (AMECO) will be applied.

First of all, there is a lack of data for post-socialist countries, which forms the bottleneck of the analysis. Therefore, the year of 1995 has been chosen as the beginning of the research, while the end of study is 2007, as the fiscal data, the revenues and expenditures of the states have been influenced significantly by the economic crisis (which erupted globally in 2008). The results of this view are, on the one hand, that the processes of the last few years are missing from the analysis, but on the other hand the analysis manages to avoid groundless conclusions based on the data of previous years. Moreover, the results of the literature are expanded both in time and in space. The period between 1995 and 2007 was divided into three time spans (1995–99, 2000–03, and 2004–07). The analysis generally applies the average of these periods.

The countries in the analysis were separated into two groups as Western/Eastern LMEs and CMEs, on the basis of Hall and Soskice (2001), Bohle and Greskovits (2007), and Kuokštis (2011). Although Japan is located in Asia, it will be considered as a Western country in this analysis, since it has similarities to CME countries based on Hall and Soskice (2001). The Western LME group includes the United Kingdom, Ireland, and Canada (LME Western); while the Western CMEs are Austria, Belgium, Denmark, Finland, Germany, the Netherlands, Sweden, Iceland, Norway, Switzerland, and Japan (CME Western). In the course of the research Estonia, Latvia and Lithuania were regarded as liberal market

economies (LME CEEC); while the CME group includes the Czech Republic, Hungary, Poland, Slovakia, and Slovenia (CME CEEC). The two groups of countries will be referred to in the analysis as Western and Eastern countries as a result of the different historical roots and geographical positions.

The following four hypotheses will be tested by applying statistical data: 1) The proportion of tax revenues to GDP is lower in the LMEs than in the CMEs regarding Eastern countries, and the ratios are similar to the values of the Western countries. 2) The proportion of social expenditures to GDP is lower in the LMEs than in the CMEs regarding the Eastern countries, and the ratios are similar to the values of the Western countries. 3) The size of the state has been decreasing both in LME and CME countries, similarly to the trends of the Western states. 4) Similarly to Western countries, there is no convergence between the LMEs and CMEs among the Eastern European economies.

Considering the first hypothesis it can be stated that the proportion of state revenues to GDP is higher in the CMEs than in the LMEs both in Western economies and new EU member states in each of the three time spans between 1995 and 2007 (Table 4.2). Furthermore, in the two regional variants of the LME model, the values of the data are around between 28% and 31%, while in the two types of the CME model the rates spread between 33% and 36%. In sum, hypothesis 1 has not been refuted.

The first hypothesis is reinforced by the fact that there are other similarities between the Western and Eastern countries, according to the more detailed analysis of revenue data. Focusing on state revenues it can be said that in accordance with the results of Campbell (2005) and expanding the regional and time horizon of former studies, in both regions the proportion of social contributions to state revenues in the CMEs exceeds the rate of the LMEs'. An opposite outcome of this result can be noticed regarding some other state revenues, as the proportion of taxes on income, profits, and capital gains to revenues is higher in the LMEs than in the CMEs considering the Western countries, which is also in accordance with the former results of Campbell (2005). However, in the new EU member states there is no relevant difference between the data of the two variants of capitalist economies. It should also be noted that taxes on goods and services have different results within the Western and Eastern countries. The LMEs have higher proportion of taxes on goods and services over the CMEs in the Western economies, while the opposite can be experienced in the group of the new EU member states.

Table 4.2. State revenues in LME and CME economies.

	Revenue, excluding grants (% of the GDP)			Social contributions (% of the revenue)		
	1995–99	2000–03	2004–07	1995–99	2000–03	2004–07
LME Western	30.1	29.1	29.6	18.5	19.3	20.1
CME Western	36.1	35.9	34.4	35.2	30.7	27.5
LME CEEC	30.8	27.2	28.0	33.5	33.8	31.4
CME CEEC	34.9	34.7	33.5	38.5	39.0	38.9

	Taxes on goods and services (% of the revenue)			Taxes on income, profits, and capital gains (% of the revenue)		
	1995–99	2000–03	2004–07	1995–99	2000–03	2004–07
LME Western	24.5	23.8	22.8	42.3	42.3	42.4
CME Western	28.1	30.8	30.8	22.9	24.6	27.2
LME CEEC	38.8	39.9	38.4	14.5	13.4	15.6
CME CEEC	33.6	32.6	33.6	15.4	16.8	15.7

Source: own calculations based on the data of European Commission (2013).

With regard to the second hypothesis, it can be said that in the case of the proportion of the social benefits to GDP, the CMEs spend 3 to 5 percentage points more than the LMEs both in old capitalist countries and new EU member states (Table 4.3). Considering the full range of time period, the higher rate of generosity in CME economies regarding social transfer in kind compared to LMEs is true only in the Western countries, as there is no significant difference among the post-socialist states regarding the two models of capitalism. Based on the analysis of the trends it can be stated that with time these kinds of expenditures of the CME model exceeded similar rates in LMEs. If the social transfers in kind and the social benefits are summed up, it can be said that the CME countries spend more on these objections than the LME economies both in Western and Eastern countries; therefore, this hypothesis, which is in accordance with the VoC theory, is justified.

The functional analysis of the disposable public expenditures data leads primarily to the reinforcement of the previous hypothesis. The proportion of public spending on health care to GDP is higher in the CMEs than in the LMEs in both regions. Among Western states the CME econo-

mies spend more on public education than LME countries, while among Eastern European states the opposite was true between 1995 and 2003, and there was a slow convergence in the value of the education data. Based on previous trends it can be assumed that if the theorem of complementarities of the VoC is true and if the crisis had not happened, then theoretically a similar order could have been achieved in the new EU member states considering the CMEs and the LMEs.¹

Table 4.3. Public expenditures in LME and CME economies.

	Social benefits other than social transfers in kind (% of the GDP)			Social transfers in kind (% of the GDP)		
	1995–99	2000–03	2004–07	1995–99	2000–03	2004–07
LME Western	11.6	10.3	10.6	11.0	11.1	11.7
CME Western	14.8	14.1	13.8	12.7	13.1	13.5
LME CEEC	10.8	9.9	8.6	11.7	13.4	15.6
CME CEEC	14.4	14.4	13.9	15.4	16.8	15.7

	Public spending on education, total (% of the GDP)			Public spending on health care (% of the GDP)		
	1995–99	2000–03	2004–07	1995–99	2000–03	2004–07
LME Western	5.1	4.8	5.0	5.5	5.9	6.5
CME Western	5.9	5.5	4.9	6.5	6.9	7.2
LME CEEC	5.9	5.5	4.9	4.4	3.9	3.9
CME CEEC	4.6	4.8	4.9	5.4	5.5	5.3

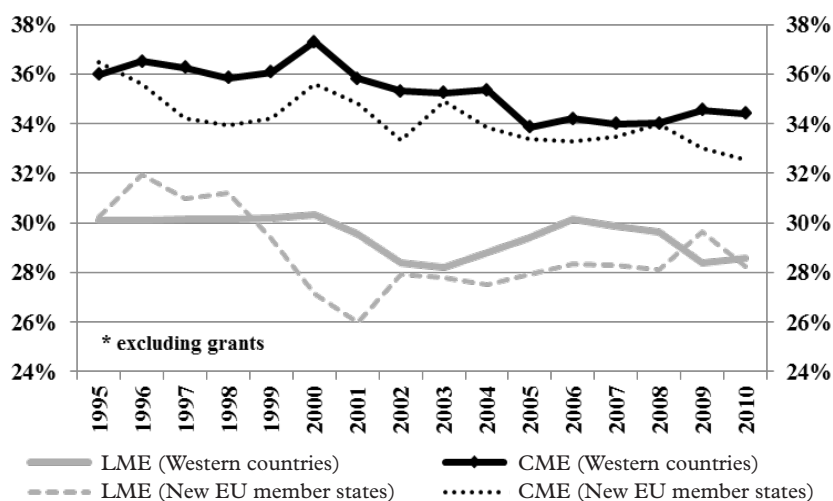
Source: own calculations based on the data of European Commission (2013) and World Bank (2013).

With regard to the third hypothesis, and considering the proportion of tax revenues to the GDP, it can be remarked that there is a decrease in the proportion, although this decrease is not a steady one (see Figure 4.1, Table 4.2). Regarding the average of the periods of 1995–99 and 2004–07, there were decreases of 0.6 and 1.8 percentage points in the LMEs and

¹ It should be noted that between 2008 and 2009, which is quite a problematic period as the consequence of the distorted data, the difference widened between the two variants of Eastern European capitalism.

CMEs respectively regarding the Western states, while the set-backs were 2.7 and 1.4 percentage points in the Eastern LMEs and CMEs respectively. The tendency also shows a decline if the annual data of 1995 and 2007 were compared instead of the average of the two periods. In sum, the proportional rate moved in the same direction in the four groups of countries, which can be explained by the increasing “tax race to the bottom” among the economies—a phenomenon not considered by earlier studies (e.g., Campbell 2005).

Figure 4.1. Revenue-to-GDP ratio in LME and CME countries.



Source: Own figure based on the European Commission (2013).

Note: Revenues excluding grants.

Before the analysis of the fourth hypothesis it must be stated that the results here are very sensitive to the choice of the time period. As mentioned above, considering the proportion of state revenues to GDP there was some convergence among the Western LME and CME models comparing the periods of 1995–99 and 2004–07, while there was some divergence among the Eastern models of capitalism. However, if the data of 1997 and 2007 are compared, then there is convergence both in the Western and the Eastern states, as the decline rates in the CMEs were higher (2.0 and 3.0 percentage points respectively) than in the LMEs (0.3 and 2.0 percentage points respectively). Accordingly, the fourth hypothesis has not been justified on account of the sensitive data and mixed results.

Moreover, it must be remarked that fundamentally there is no substantial difference between the Western economies and the new member states, at least the results do not question the similarity between the institutional development path of old capitalist countries and the new EU member states.

4 Conclusion

Varieties of Capitalism has been considered as quite a new theory in economics literature only from the beginning of the millennium onwards, in spite of its old roots. Although there were functional extensions of the theory in more directions and there is a broadening literature with increasing number of empirical results, the regional widening of VoC toward Africa, Asia, and Eastern Europe has begun only in the past few years.

This analysis focused on the degree to which the characteristics of Western models of CME and LME economies can be observed in various public finance issues of Eastern European countries. The results of the empirical analysis show that both the proportional rate to GDP and the structure of the revenues and expenditures are similar both in the Western and Eastern CMEs, and in the Western and Eastern LMEs as well. It has also been verified that the size of the state has been decreasing as a consequence of globalization. This is not in accordance with the previous results, showing that the states play an increasing role in public finance, though it is accepted (along with other studies) that the direction of the models is the same. With regard to the last hypothesis, the data have shown to be sensitive to the chosen period; therefore, it cannot be decided at this point whether there is convergence between the LMEs and CMEs among the Eastern European economies or not.

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CHAPTER 5

Passive Macroeconomic Populism in the Baltics

Gábor Kutasi

1 Introduction

The economic story of the emerging Baltic countries seemed to be a success up until 2007. They were small, open economies with a sustainable and low public debt, and a five to eleven percent permanent annual GDP growth rate; they became member states of the EU, and got rid of the Soviet economic heritage. The region seemed to be very disciplined in a fiscal and monetary sense from the very start of their independence. In the first half of the 2000s they even managed to produce robust economic growth and significant real convergence as compared to the more developed EU members. The region has proven to be attractive for capital investment. However, economic analyses have projected structural problems in their external (im)balance. These countries, characterized by balanced policies, came to a sudden halt in 2007, which was further exacerbated by the global crisis. If the fiscal balance, debt sustainability, and the fixed exchange rate was secure, then what could have undermined the growth potential? Behind the fine indicators that were considered to be important, the external imbalance of the Baltics showed a deficit that increased with each year. Finally, the external indebtedness problem undermined sustainable growth. Moreover, the Baltic convergence also signalized the imperfection of the Baltic economic success. The currency board-based economic policy produced more than excellent public finances and debt numbers, which were directly under the influence of policy makers. However, inflation, as an indirect indicator of policies, brought about a series of failures in monetary integration. This chapter

examines the origins of the sudden economic stop and the failure of price stability aspirations. External imbalance caused by passive macroeconomic populism will be put under test in view of the Baltic economies.

Accordingly, the chapter examines the political economy of current account imbalance in the Baltic countries, where the public finances have seemed to meet mainstream economics, and the pegged exchange rate has proved to be sustainable. The origin of the problem is assumed to be macroeconomic populism. The Baltic states show a weird form of populism, referred to as a passive kind in the study. In market economies without significant rent-seeking opportunities from commodity resources, the private sector provides most of the income sources. This way, populist politicians will not be generous spenders, but undisciplined delayers of restrictions. What is common in the active generous spender and the passive delayer is that they wish to favor electoral groups by securing a higher income, and neither of them worry about long-term inflation undermining the sustainability of growth. Although this chapter focuses on the Baltic region, passive macroeconomic populism as an explanatory factor can be extended to many emerging countries which build their growth on secondary and tertiary export and foreign direct investment from Eastern Europe to South-East Asia, and which have suffered a sudden stop in dynamic economic expansion.

2 The relationship between macroeconomic populism and external indebtedness

In the single European market the individual external balance of member states has become a neglected aspect. In the case of the catching-up member states with inflation beyond the average, the single central bank rate proved to be too low in the sense that credit was very cheap and it was preferable to spend it when it was available instead of saving it for the future. This counter-selection of the single monetary policy is an important factor, as the Baltic states' current account deficit was accumulated through foreign currency (euro) credits. Thus, it was not the national, but the single central bank rate that mattered to the market. Meanwhile, the Baltic way of monetary convergence with a strictly pegged foreign exchange caused non-adjustable real appreciation, since it worked as a peg toward the core countries with a single currency within the EU. This characteristic ruined Baltic wage competitiveness by increasing the wage demand caused by higher inflation. The additional inflation and

the increasing wages originated in external credit money through additional demand. The relatively cheap credit—which *a priori* originated in non-local sources—financed mostly the consumption of imported products and services. This could be maintained only up until any one of the global financial actors were willing to seek risky emerging market items. The Baltic recession situation—originating in the external indebtedness—reveals the trap of those periphery countries in the Eurozone which wasted the single currency advantages to finance cheap import from foreign private credit. The currency board countries cannot devalue their currency to improve the current account, nor have the public debt depreciate through inflation without damaging monetary and fiscal credibility (Kutasi 2012:717–8).

In the Baltic case, where the euroization of the credit market was supported by policy makers, thus significantly influencing monetary processes to become lost, the Baltic private debtors calculated with the euro rates. By looking at the time series of effective exchange rates and unit labor costs, it becomes apparent that there has been a real appreciation in the member states with high inflation in comparison to ones with low inflation in the single currency zone, without any local monetary intervention. Calculation is used to show the real appreciation problem of Baltic countries against lower-inflation ones in the single currency zone without any effective monetary intervention in the currency board regime. This reverse Balassa–Samuelson impact would have been a motivating factor for excessive intra-community import in externally indebted countries. The survey on decreasingly competitive wages of countries suffering from real appreciation is an explanation for a loss of competitiveness in their export and for the relative cheapness of import.

2.1 *The political economy of macroeconomic populism*

On the basis of their Latin American observations, Dornbusch and Edwards (1989:2–5, 1991:7) understood macroeconomic populism as the heterodoxy of economic policy making. Namely, when the economy gets wind for a while, policy makers start policy actions which make them popular in the short term. But it does not mean simply spending money. The paradigm of macroeconomic populism results in an interim increase in living standards through macroeconomic stimuli, just like excessive fiscal and credit policy and overvalued currency. The core element of the paradigm is the redistribution of attaining development without experiencing social conflicts. Meanwhile, populists neglect the importance of the

risk of inflation, the risk from deficit financing, the external constraints and the reaction of global market actors on non-market-like policies. This approach can result in a short-term growth and recovery period. Nevertheless, policy makers ignore the fiscal and external constraints, and these bottlenecks cause recession and crisis in the medium term, as the constraints make heterodoxy unsustainable. Finally, according to Dornbusch and Edwards (1991:7–8), the long-term outcome of macroeconomic populism will be the “plummeting of real wages,” “severe” difficulties in balance of payment, “galloping inflation,” crisis, and the “collapse of economic system.” These “developments” will enforce austerity and demand for external (IMF) aid.

Based on the observations by Darvas and Szapáry (2008) describing the economic trends and risks in the Eastern EU member states, Csaba (2008) discovered a similar but different kind of macroeconomic populism in the EU10 region.¹ According to Neményi and Oblath (2012: 596), not only those countries got into trouble which have been under an excessive deficit procedure of the Community. The Baltic sudden stop in 2007 or the Slovenian indebtedness problems in 2012 appeared in countries with a sustainable budget balance. Divergence in inflation, competitiveness, and a relative wage cost was already observable among the Eurozone countries.² Unlike Latin American active populist policy, Csaba (2009:111–2) determines the “new kind” of macroeconomic populism as a passive policy making by delaying reforms and unleashing private demand financed by loan. Unlike, again, the Latin American heterodoxy, Csaba (2008:602) establishes that the new kind of macroeconomic populism correctly follows the simplified models of “elementary economic textbooks.” This characteristic originates in the European economic circumstances, where typically there are no significant opportunities for rent seeking in public finances from natural raw material resources. That is why the European version of populism can affect living standards mostly passively on by not levying more taxes in the revenue channel or by not blocking the private consumption in the regulation channel. This will result in a short-term “boom driven by the private sector and personal consumption” Csaba (2008:603).

¹ The Southern members—Greece, Italy, Portugal, Spain—can be mentioned as bad examples of the Latin American kind of macroeconomic populism, as it was observed by Neményi and Oblath (2012) or Kutasi (2013).

² For example, the cumulated growth of ULC (unit labor cost) between 1999 and 2006 was 1.5% in Germany, but 25.2% in Greece, 23.2% in Spain, and 27.7% in Portugal (Neményi and Oblath 2012: Table 1).

The initial condition of macroeconomic populism is dissatisfaction within society and among politicians about national economic performance in stagnation and expectations for better dynamics. Many times, public opinion connects the stagnation to an earlier disciplined austerity in the spirit of conservative economics. In the first phase, as elaborated on by Dornbusch and Edwards (1991:11, 1989:6–7), policy makers refuse the restrictive conservative paradigm and ignore the macroeconomic constraints, as there is a temporary possibility to loosen policy conditions. The quick result of a pegged foreign exchange, fiscal expansion, credit expansion, tax cuts, etc. can result in the high growth of real wages. Although it ruins export competitiveness, the government is not willing to devalue the foreign exchange in order to avoid the inflation shock and the damage of living standards. But, in the second phase, the mentioned constraints block the ongoing dynamic growth as bottlenecks. The third phase is referred to as the situation when there are “pervasive” shortages, accelerating inflation, and foreign exchange gap (overvaluation), which characteristics initiate a capital flight, a demonetization in real economy transactions, increasing public deficit, and—finally—an unsustainable populist policy. Dornbusch and Edwards (1989) emphasize the role of external destabilization and vulnerability in the process of heterodoxy failure. Then comes the orthodox stabilization as phase four.

Concerning active and passive populism, both Dornbusch and Edwards (1989) and Csaba (2008) have established that the mix of populist policy, external world economy, and macroeconomic contexts result in an unsustainable economy where several elements get uncontrollable by policy makers. Control can be lost over inflation, the current account deficit, public debt, crediting, money supply, and monetary processes.

To implement the paradigm of populism to the case of the Baltic states, the passive kind of macroeconomic populism model can be implemented. In Darvas and Szapáry's (2008) view, beside the high speed of growth of 2000–06, the Baltic states accumulated a high annual current account deficit, their pegged foreign exchange strengthened the price convergence, and in 2007 they got into recession with high inflation. It was also recognized that the euroization of their credit market (52–77%) increased significantly (p. 847). This characteristic severely reduced the influence of monetary policy on monetization; at the same time it proves the passivity of populist policy. The euro credit got very popular as it was based on the EURIBOR rate, much below the Baltic rates. It also had positive economic results in form of an interest rate convergence that could verify the policy makers' passivity. Darvas and Szapáry (p. 855) even supplement the origin

of reduced monetary transmission by mentioning the competition in the banking sector in the 2000s, which also lowered the credit rates.

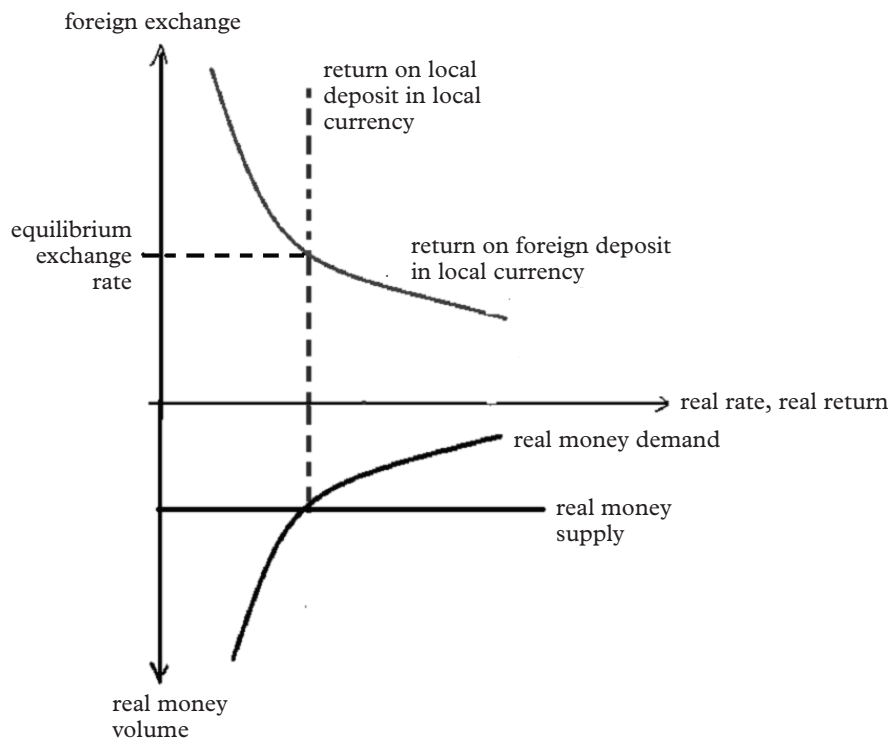
The phases of macroeconomic populism described by Dornbusch and Edwards (1991) is valid for the Baltic countries, too. The Soviet era and the first half of the 1990s were the period of strongly repressed consumption; thus, the households desired more. The growth period of the region and global financial instruments made it possible (see below the Feldstein–Horioka puzzle) that a significant share of Baltic consumption and investment got financed from foreign sources. Of course, politicians did not want to obstruct the increase of welfare from external credit, as it raised the placidity of people. Besides the toleration of low monetary transmission, the Baltic policies targeted low public duties. Csaba (2008) summarizes the failure of macroeconomic populism in the Baltic (and East-Central European) region as follows: 1) cuts on public duties; 2) passivity in an overheated economy; 3) focus only on fiscal balance; 4) delay of structural reforms; 5) no political consensus; 6) winner-takes-it-all behavior in politics; and 7) elemental breakthrough of private demand after decades of repressed consumption. This process caused an enormous current account deficit and high inflation (see below the reverse Balassa–Samuelson effect). Finally, bottlenecks appeared in the Baltics, too.

2.2 Exchange rate policy aspects

The Baltic internal economic balances originated in the primacy of monetary policy which targeted first of all exchange rate stability. In the case of Estonia and Lithuania, the currency board system has been applied, and the Latvian monetary policy also targeted a pegged rate with some adjustment cases. The purpose of the currency board is to copy the price stability of the reference (key currency) country/region. The Baltic monetary policies hoped to adjust the national price stability to the one in the Eurozone by pegging. The currency board is in a quasi-single currency position, as there is no exchange rate volatility at all (toward the euro), and actually the monetary policy is very strictly bounded, without any room for non-harmonized maneuver by the exchange rate target. The national currency is pegged rigidly to the key currency and the peg becomes the anchor of economic policy as a primary target. Price stability will be a necessity to keep the relative purchasing power of the national currency. Basically, the currency board is credible if the national inflation keeps pace with the reference region. Of course, economic policy instruments are also usable for exchange rate stability. Namely, a higher central bank rate, via the interest

rate parity, can strengthen the demand for the national currency, or the public budget surplus can reduce the commodity market demand through the purchasing power parity on the one hand and inflation on the other to keep the foreign exchange peg. (The peg has been 15.6466 EEK and 3.4528 LTL to 1 EUR.) It is concluded from the interest rate parity model that the policy on interest rate and money supply must be subordinated to the rigid target of foreign exchange (see Figure 5.1).

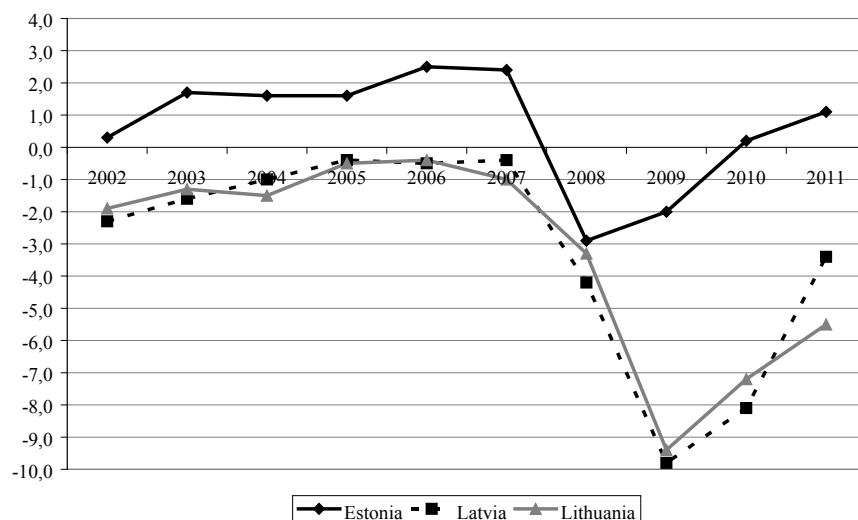
Figure 5.1. Context of interest rate parity.



Source: Author's own compilation based on Krugman and Obstfeld (2002).

Moreover, for the financial market equilibrium depending on the GDP and real interest rate, the equilibrium of money demand and supply must be controlled by the fiscal revenue and spending items. In case of emerging countries like the Baltics, the inflationary impact from the Balassa–Samuelson effect should be buffered in the way of public distraction from private demand (see Figure 5.2).

Figure 5.2. Budget balance in Baltic countries, % of GDP



Source: Eurostat statistical dataset (2013).

Full pegging can be advantageous only in case of a credible economic policy, but even if the fundamentals are correct, the peg still can endanger economic growth. In case of overvaluation, the wage competitiveness of the economy using the currency board deteriorates badly in international trade. This can produce a fall in export revenue. Meanwhile, the local households perceive an increasing real income due to overvaluation and start to increase their import consumption. Thus, pegging can cause contraction after a temporary economic boost. Both the South-East Asian currency crisis in 1997 (Krugman and Obstfeld 2002) and the Baltic recession in 2006–08 (IBRD 2007) gives empirical data to support this thesis. In both cases, a strong deterioration of the external balance and a sharp slow-down of economic growth were observable. Because of the danger on competitiveness, the countries with peg find themselves in a dilemma: do they want to reserve their monetary credibility by insisting on the peg, or should they devalue to improve the competitiveness and thus the external balance?

The Latvian pegging has been very close to the currency board. Since 2005, Latvia has participated in the ERM II system, with a special individual unilateral commitment, namely that the Bank of Latvia guaranties a

+/-1 percent floating margin. The central peg has not been changed since 2005; it is 0.702804 LVL to 1 EUR and the volatility has been kept in the guaranteed margin.³

As Baltic countries use strict pegging, their case has been very similar to that of the single currency zone members in the sense of external adjustment without revaluation of foreign exchange. When it comes to examining the intra-community movement of products, services, and transfers in a quasi-single currency situation, the object of study is a quasi-homogeneous money market, just like the gold standard system or the gold coins of the Middle Ages. In case of the currency board, only technical exchange costs made the Estonian krooner and the Lithuanian litas different from the euro. In the sense of exchange value, the quasi-single currency is as homogeneous in the intra-zone trade as the global value of gold. This case can be surveyed by two methods. The first one is based on nominal adjustment, whereby the flexible price level mechanism or the automatic monetary mechanism can be used to explain the balance of payment procedures in a homogeneous international money market situation (Szentes 1999). In this approach, built on the theory of David Hume and Milton Friedman, the expectations say that if there is an external imbalance, the volume of euro is accumulated in one part of the euro states and the rest of the euro states will accumulate the products. The excessive money supply and absence of products in the countries with trade surplus should cause an increase in local price and, thus, a bigger demand for import from the countries with trade deficit, as the latter ones have a shortage of money and an excessive product supply. Therefore, the decreasing price level is expressed in the quasi-single currency. The flexibility mechanism has not worked. As there has been a commitment to avoid the flexible exchange rate mechanism, there has been no monetary adjustment against external imbalance in the Baltic countries. It can be established that the Baltic economies have “desired” the single currency—Estonia already achieved it in 2010, Lithuania introduced it in 2014—; thus, in their strictly pegged rate system there is no monetary autonomy. Besides, there are tax differences and fiscal differences in comparison to other Eurozone countries. Moreover, labor market imperfections exist. Therefore, the assumption of a perfect equilibrium and the distortion-free movements of factors and commodities are missing from the practice, although the neo-classical model is based on them.

³ Source: <http://www.ecb.int>; <http://www.bank.lv>.

The second method based on real adjustment can be a starting approach for the further analysis of pegged-zone imbalances. This is built on the Keynesian automatic income adjustment mechanism. It focuses on the imbalance of savings (S) and investment (I), and it derives the current account (CA) from the imbalance of trade, capital market and public sector: $Y = C + I + G + X - IM$; where Y is the output, C is the household consumption, G is public consumption, X is export, IM is import. Accordingly, savings are as follows: $S = Y - C - T$; where T is tax revenue of the government. T is equal with G if there is budget balance, but obviously, according to Baltic practice it is preferable to calculate with a robust surplus or a slight deficit. Accordingly, $X - IM = (S - I) + (T - G)$ and $CA = S - I + \text{Budget Balance}$. On the basis of this last equation, the Keynesian conclusion is that if there is a current account deficit, adjustment can happen only through real terms. Namely, savings must be raised—parallel consumption decreases, or investments must be decreased, or the public budget should show less deficit/more surplus (Szentes 1999; Benczes 2008; Afonso and Rault 2010). From a public finances view the public savings with the Baltic surpluses or sustainable deficits are appropriate, but the difference of private savings and investments are in a massive deficit ($S_{\text{private}} - I_{\text{private}} < 0$).

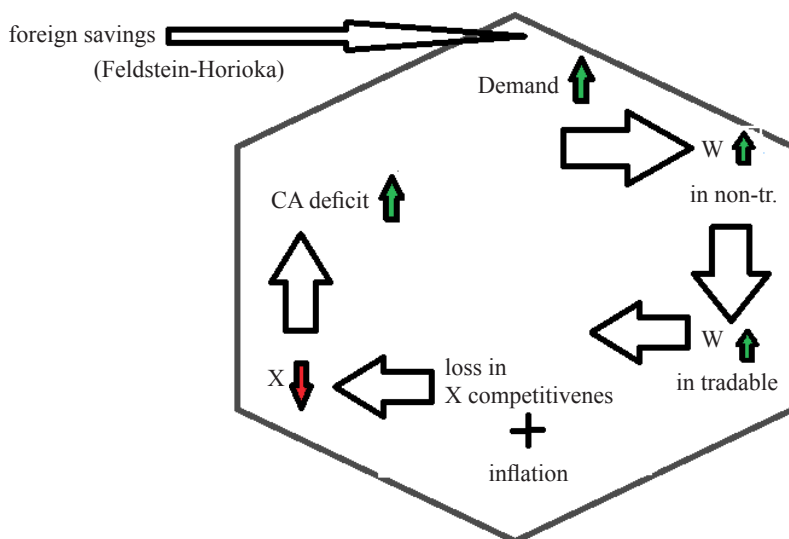
The Mundell–Flemming model is an advanced eclectic model of the Keynesian IS–LM model approach on external balance. In case of externally indebted countries in a quasi-single currency zone, the version with pegged foreign exchange rate and fiscal expansion is relevant (Benczes and Kutasi 2010). In the theoretical model, the assumed process is that fiscal expansion results in a higher interest rate, which triggers a capital influx. To protect the pegged foreign exchange, however, the monetary authority has to increase money supply, which pushes interest rates down. The double expansion (i.e., expansive fiscal and monetary policy) results in a higher GDP.

But why does the model version not work in case of the European (quasi) single currency pegging practice? As it is described in the optimum currency area model by Mundell (1961), McKinnon (1963), and Kenen (1969), national economies can adjust individually to asymmetric shocks in an economic community by a flexible factor market, monetary policy, or community funds. The factor markets are not perfect, especially the workforce mobility in the EU. The monetary policy is community competence in the Eurozone; namely, it is not able to consider asymmetric impacts in its action. Only fiscal instruments remain, but most of the fiscal actions must be done at the national level, as there is no significant fiscal redistribution at the monetary community level.

2.3 Recession model of external imbalance

It is worth emphasizing that in an open economy savings and investments can correlate very weakly with one another, unlike in a closed economy assumed by Keynes, where savings and investments are assumed to be equal. Obstfeld and Rogoff (1996), in their “new open economy model,” emphasized the phenomenon of free international movement of national savings; thus, the free international financing of investments, which is referred to as the Feldstein–Horioka puzzle (see Feldstein and Horioka 1980). Regarding the Feldstein–Horioka puzzle, Afonso and Rault (2008) state that if savings and investments are not correlated, the budget deficit and the current account deficit “tend to move jointly.” The mechanism is displayed in Figure 5.3.

Figure 5.3. Mechanism of the reverse Balassa–Samuelson effect in a national economy.



Source: Kutasi (2013:Figure 1).

Notes: **Demand**: demand of consumption; **w in non-tr.**: wage level in non-tradable sector; **w in tradable**: wage level in the tradable sector; **X**: export; **CA**: current account. White arrows show the causal relations, while grey arrows show the change of variable (↑: increase, ↓: decrease).

As there has been neither an individual devaluation nor a federal bail-out mechanism, the unsolved external imbalance can result in the divergence, regression, and degradation of externally indebted countries. This is the so-called reverse Balassa–Samuelson effect (see Grafe and Wyplosz 1997;

Jakab and Kovács 2000:144). The original Balassa–Samuelson effect derives the higher inflation of catching-up countries from the development of productivity in the catching-up tradable sector, which causes a wage increase and thus inflation pressure in the non-tradable sector (Balassa 1964). The reverse Balassa–Samuelson effect, however, claims that the relative change of price leads to a divergence of productivity. That is, in the Eurozone, the quick convergence of interest rate imposed an overheating in consumption in its periphery economies. The expectations of households based on a sharply decreasing interest rate were unfounded, and resulted in a quick private indebtedness, particularly through the consumption of non-tradable services. This latter impact raised the wage demands in the local non-tradable sector that spilled over to the tradable (export) sector. Thus, the export competitiveness deteriorated; meanwhile, the local inflation rose by the higher wage cost (Mongelli and Wyplosz 2008; Neményi and Oblath 2012).

Moreover, Lane and Perotti (1998), Beetsma et al. (2008), and Benetrix and Lane (2009) found that increasing public spending in the Eurozone countries shifted the demand toward the non-tradable sector, which resulted—logically—in increasing wages. Accordingly, the fiscal processes contributed to the emergence of a reverse Balassa–Samuelson effect. However, Lane and Milesi-Feretti (2002) found only a limited correlation between public debt and external imbalance in highly developed countries.

According to De Santis and Lührmann (2006) and Gavilán et al. (2011), the current account is determined by the following factors:

- The demography impact on the structure of consumption and savings (Ando and Modigliani 1963).
- Real GDP growth and its impact on savings (Modigliani 1970) or on consumption based on future incomes (Tobin 1967; Farrell 1970).
- International competitiveness based on REER.
- Stages of development: there is a U-shape relation assumption between CA balance and relative per capita income.
- Positive correlation between money stocks to GDP and savings (Edwards 1996; Chinn and Prasad 2003).
- The continuity/smoothness of growth of labor productivity (Glick and Rogoff 1995).
- The inherited debt, i.e., the “original sin.”
- The effect of transparency on lower risk.
- Restrictions on current account and capital account (e.g., capital control).

- Deviation from uncovered interest rate parity.
- Portfolio impact: sometimes the investors sell their low risk bonds with high yield to counterweight their loss on risky bonds, and thus rebalance their portfolio (Bohn and Tesar 1996).
- Market valuation impact: how the investment products are over-valued according to P/E and the fundamental value ratio.
- Effect of size of a company or a country (Banz 1981; Asness et al. 1997; Bekaert et al. 1997). The less capitalized country pays a higher return.
- The investment and capital demand of national industries.
- The external financing demand and crowding-out impact of the public finances.
- The impact of crisis through GDP contraction, negative wealth shock on saving assets, increasing public spending, and the end of plenty of international credit money.

3 The development of the Baltics in transition and integration periods

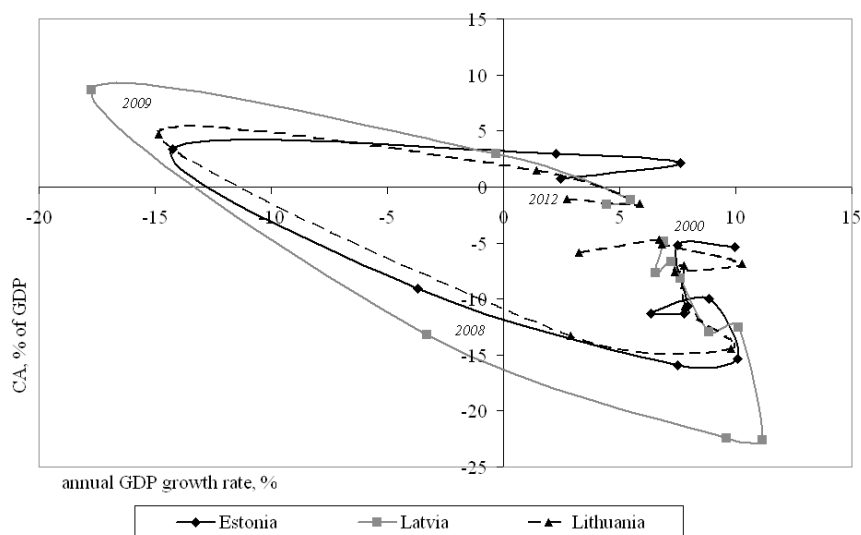
3.1 *Minimal state with fiscal discipline*

After the collapse of the Soviet Union, one of the few advantageous heritages of the Baltic countries was the very low level of public debt, around 5 percent of the GDP. This could have created a robust room for maneuver for fiscal populism. However, the Baltic governments avoided its use for fiscal easing and political populism.⁴ This opportunity was utilized to reform the system of social services and shift the Baltic society and economy toward a liberal (Anglo-Saxon) social model with private financing. Economic growth and welfare were based on the influx of foreign direct investments and other capital sources. Nevertheless, the public balance and monetary stability were not enough in themselves to bring along a quick success in the monetary integration, as they did not have enough impact on inflation. Since companies and households have accessed cheap foreign loan, none of the budget surpluses and central bank rates could control and restrict the national consumption and investment and their impact on inflation. Constantly missing the inflation target criterion, the Baltic monetary integration eventually slowed down. Meanwhile,

⁴ See Chapters 2 and 3 of this volume.

their euroization reached a high level through loans. At the end of 2006, the financial euroization of the loan market was approximately 52 percent in Lithuania, 76 percent in Latvia, and 79 percent in Estonia (Chitu 2012:Chart 1). These data strengthen the thesis that monetary transmission has been very weak in the Baltics. Figure 5.4 shows the connection between income growth and the current account of Baltic economies. Between 2000 and 2006–07, these countries had a regionally outstanding growth, beside an extremely negative and deteriorating current account balance. Only the GDP contraction shock could have caused the Baltic economies to break the deteriorating trend of external imbalance. The global shortage of credit money enforced the three economies to give up the import financed from debt. However, after the annual flow surpluses of the contraction years, namely 2009–10, as economic growth returned to the region, the current account turned into a moderate deficit yet again.

Figure 5.4. GDP growth rates and the balance of the current accounts, 2000–12.



Source: IMF World Economic Outlook (October 2012).

Note: Data as percentage of the GDP.

The main thesis, i.e., that these economies were overheated by foreign money, can be verified by the output gap data. E.g., the Estonian output gap was massively positive (beyond the potential) before the global crisis (see Table 5.1).

Table 5.1. Output gap of Estonia, percentage of potential GDP, period of 2000–12.

2000	-1.661	2007	10.868
2001	-1.174	2008	4.946
2002	-0.649	2009	-9.797
2003	-0.186	2010	-7.62
2004	-0.321	2011f	-1.579
2005	2.497	2012f	-0.979
2006	7.198		

Source: International Monetary Fund and World Economic Outlook Database (October 2012).

Note: f: forecast.

The overheated economy was particularly based on external loans, as well as on tax cut competition among the Baltic fiscal policies. Furthermore, the business cycle strongly synchronized with the Russian economy, which was boosted by the oil price boom of 2002–07.

The global financial crisis hid a default risk from the foreign exchange rate, originating in the pegged rate and currency board regimes. The peg motivates market actors to become indebted in euro with a lower reference rate. Table 5.2 documents that all the major Estonian actors borrowed money mostly in foreign currency. Figure 5.5, on the one hand, represents the acceleration of foreign credit demand of the Lithuanian economy. On the other hand, it is clear from the figure that the financial sector was the main channel of foreign credit promotion, as most of the capital import was composed from foreign credit channeled in by monetary financial institutions (namely banks) and financial corporations.

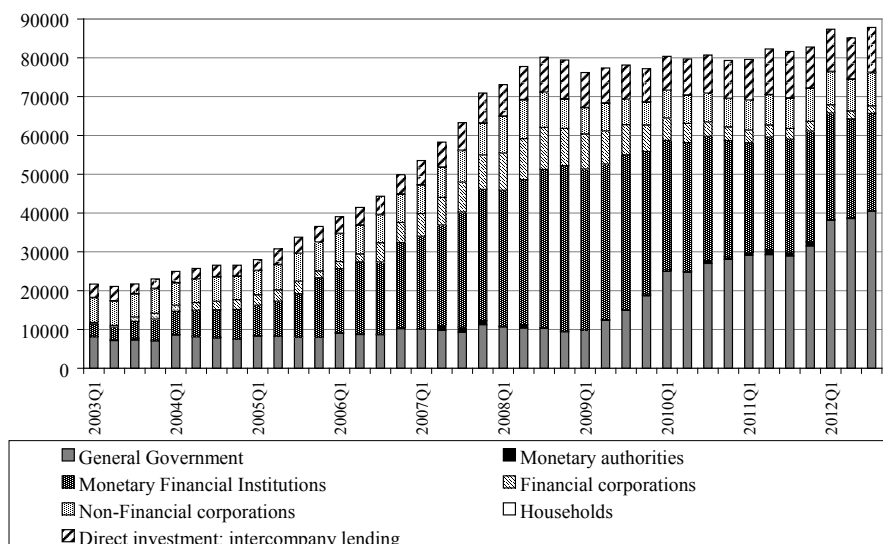
Table 5.2. Share of foreign currency (mostly euro) loan of resident actors in Estonia.

	2004	2005	2006	2007	2008	2009	2010
Government	80.09%	80.41%	74.23%	74.06%	87.59%	92.02%	94.53%
Financial institutions	97.48%	98.50%	92.50%	94.16%	98.12%	98.88%	93.90%
Non-financial comp.	78.78%	75.98%	75.66%	78.02%	86.23%	89.96%	93.18%
Households	65.01%	75.08%	77.83%	77.32%	82.26%	83.94%	86.36%

Source: Eesti Pank, Financial Sector Statistics (<http://www.eestipank.ee/en/statistics>).

Note: Calculation is from year-end stock data.

Figure 5.5. Structure of the Lithuanian gross external debt.



Source: Lietuvos Bankas, External statistics (http://www.lb.lt/external_statistics_1; February 17, 2013).

Note: "Monetary financial institutions (MFIs) are central banks and resident credit institutions as defined in Community law, and other resident financial institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than MFIs and for their own account (at least in economic terms) and to grant credits and/or make investments in securities. Money market funds are also classified as MFIs." Definition of the ECB (<http://www.ecb.int/stats/money/mfi/general/html/index.en.html>).

Escaping from the menace of the currency crisis, Estonia successfully ran forward into the Eurozone accession in 2010. Latvia demanded a 7.5 billion euro credit from the IMF and the EU, and Lithuania has tried to follow in Estonia's footsteps.

3.2 Fiscal stages in transition and integration

The first stage of economic transition ended in 1999, in which period each country had to undergo considerable fiscal adjustment programs either because of internal tensions in their public finances systems or because of international financial crises. The Baltic states typically exemplified this trend, as an aftermath of the Russian financial crisis in 1998. From fiscal aspects, the utility of this period for public finances was a chance for governments to establish a sustainable economic policy and to launch

medium-term reforms in the financing systems of high-volume social subsidies (and social investments). An inheritance from the command economy regime, the lack of transparency was regarded by the IBRD (2004) as a number of blind spots in the fiscal framework, because budgeting and policies were completely separated and there was no medium-term planning. In addition, a large number of off-budget funds existed, and the number of conditional obligations was also high. Task- and performance-oriented financing was missing, cash-flow and debt management was fragmented, and the budget was completely input-oriented. Fiscal adjustments of the first stage created a stable starting point for Baltic countries. The following period after the consolidation will be split into two separate stages, because the EU membership means stricter fiscal obligations (the countries pledged economic policy convergence in their Accession Treaty).

The second stage of the economic policy transition lasted roughly from 1999 to 2004. In this period, the candidate countries had the chance to start the creation of a system of expenditures and revenues that were sustainable in the medium term, based on a previous consolidation stage, even affording themselves a temporary growing fiscal deficit in the first years. The second stage also saw the end of big volume privatization, which had been part of the transition process to market economy. Consequently, large sums from selling state-owned corporations could no longer offset annual deficits and increasing public debts. Therefore, De Novellis and Parlato (2005) recommend an increase in tax revenues in the post-privatization period if the central budget had a primary deficit in the privatization stage. This did not necessarily require a tax hike! The objective could be realized by cutting back tax allowances or by a broader tax base, as was the case in the Baltic states, where tax rates were even reduced besides maintaining stable revenues.

The third stage, when community expectations regarding convergence were to be met, started with 2004. However, the EU membership has meant additional challenges for economic policies beyond limitations to an excessive fiscal deficit. The governments have had to contribute to the community budget and also to projects funded by community grants (Köhler-Töglhofer et al. 2003).

3.3 Fiscal positions in dynamics

In case of the striving Baltics, the typical characteristics have been stable fiscal positions, relatively low public debt ratios compared to the GDP,

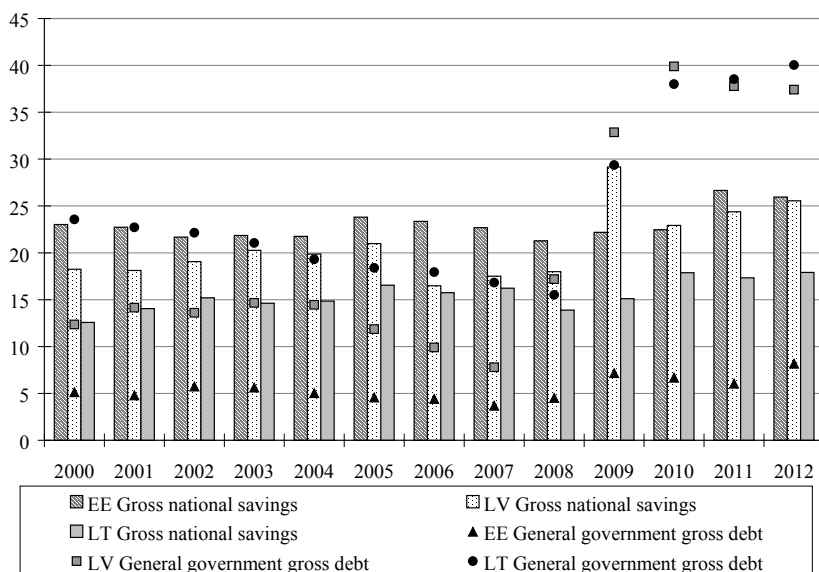
and low government spending.⁵ Basically, some risks have been evident regarding price stability, but mostly on the back of global economy developments and convergence. On the one hand, energy prices rose very dynamically in the first years of the 21st century, and on the other hand there is a serious lag behind EU15 prices and wages—with the exception of Slovenia—, but economic convergence inevitably calls for rises in these fields, too. Evidently, successful convergence requires an economic policy mixture to ensure monetary convergence for these countries (Festič and Bekő 2006:82). This is the reason for a large number of criticisms and suggestions on the part of international organizations (the IBRD, the OECD) regarding the fiscal policies of the Baltic states, as price levels are partially subject to the structure of government consumption, as well as to the taxation and subsidy system, which influences consumption and investment decisions of corporations and households.

In the Baltic states, one of the components of the legacy from the disintegrating Soviet Union was an extremely low level of public debt—roughly 5% of the GDP, which would have meant almost limitless fiscal opportunities in the foreseeable horizon for policy decision makers. However, the governments of the Baltic states—wisely—used this chance not to opt for fiscal laxity or vote-generating subsidies but, in an example-setting manner among all the EU8+2 countries, to restructure their finance system of social benefits and to accumulate a primary budget surplus. Economic growth and welfare improvement are based here on FDI influx. They had the largest maneuvering room in their budgets among the EU27 countries in terms of fiscal balance and public debt. However, all this was ruined with external imbalance. International reports—such as the ones issued by the IBRD (2007), Deutsche Bank (2006a), the IMF, the EBRD, and the European Commission—underlined external imbalance as the main risk factor.

⁵ The Baltic states had implemented flat taxes. According to Árendás et al. (2006), flat taxes are fair when they reflect the socially approved level of public contribution, and at the same time are efficient and progress-safeguarding when they eliminate tax allowances and preferences, and are also simple, which ensures a higher degree of transparency and predictability for taxpayers. This latter feature is what provides a country with an edge in the tax competition that has developed among Eastern EU member states, because it can retain the volume of revenues by widening the tax base by offering certain foreign investors simpler and lower taxes.

As Figure 5.6 shows, in Latvia and Lithuania the economic crisis shock of 2009–10 could be treated only by sharp public indebtedness, as these two countries doubled their public debt what is not anymore covered by national savings. In this sense, the Baltic troika split. Estonia remained fiscally stable, and fiscal demand for debt financing did not cause significant crowding-out of private debtors from national savings. Meanwhile, Latvia and Lithuania deteriorated their fiscal room for maneuver.

Figure 5.6. Baltic gross national savings and general government gross debt, % of GDP, 2000–12.



Source: IMF World Economic Outlook (October 2012).

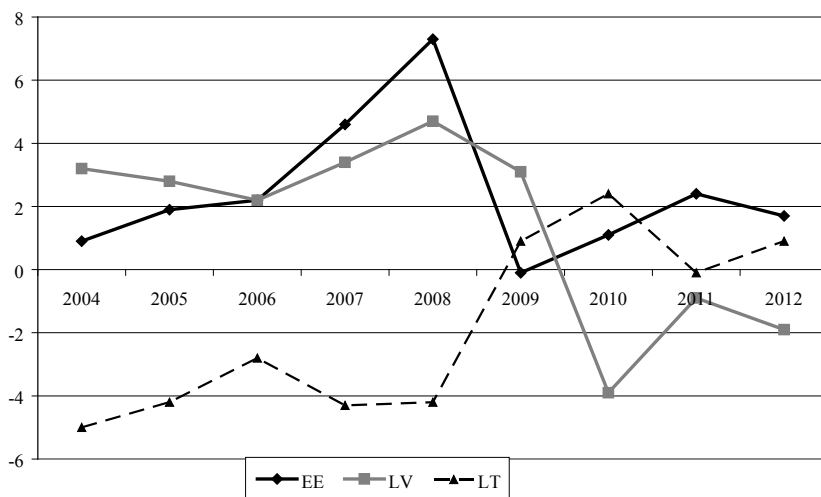
Note: EE: Estonia; LV: Latvia; LT: Lithuania.

4 Baltic external imbalance—proof of passive macroeconomic populism

In the following it will be examined whether signs of macroeconomic populism, the reversed Balassa–Samuelson effect and the Feldstein–Horioka puzzle are observable in the Baltic economies. Inflation will be first analyzed in order to understand that basically the currency board or narrow pegging does not automatically “import” the rate of the reference zone. In

the pre-crisis period, only Lithuania could perform below the Eurozone average (see Figure 5.7). (Note that this is not the Maastricht criterion on price stability.) This proves that Estonia and Latvia did not put every effort into keeping the purchasing value of national currencies up to the power of euro. Although the global crisis years created deflation impacts, only Estonia could use it for monetary integration. As it was mentioned before, the stimulus ruined the fiscal indicators of the other two countries. Returning to the pre-crisis deviation from average, additional inflation can be observed. In case of the high growth rate years of the Baltics, it would be easy to say that this was because of a normal Balassa–Samuelson effect that originated in some sort of catching-up procedure and its impact on wages in the tradable and non-tradable sectors. However, this would be a hasty conclusion to draw.

Figure 5.7. Baltic deviation from the Eurozone average.



Source Eurostat database (February 16, 2013).

Notes: Deviation from Eurozone average inflation = national inflation – Eurozone inflation, percentage point; Eurozone = current members in a year, percentage point. EE: Estonia; LV: Latvia; LT: Lithuania.

What is clear from Table 5.3 is that the Baltic countries are uncompetitive in trade relation with the center of the EU, Germany. An increasing German surplus is recognizable from the German trade balance. A similar conclusion can be drawn from the change of terms of trade (see Figure 5.8). The price-based index expresses a relative increase in export prices

in the first years of Baltic membership in the EU, before the crisis. Pegging seemed to be harmful for export competitiveness.

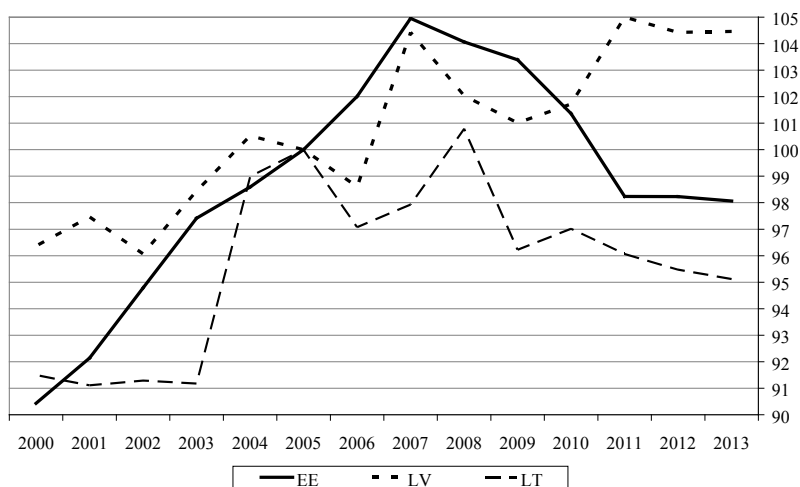
Table 5.3. German trade balance with Baltic countries, 2004–07 and 2011.

	2004	2005	2006	2007	2011
EE	342	650	954	1078	1018
LV	443	532,4	864,3	1194,3	664,6
LT	743,2	804,8	1221	1251,9	513,3

Source: DESTAT Statistische Jahrbuch für die Bundesrepublik Deutschland 2008 and 2012 (www.destat.de).

Notes: In million euros. Positive values indicate German surplus.

Figure 5.8. Terms of trade, ratio of export, and import price deflators, 2005=100.



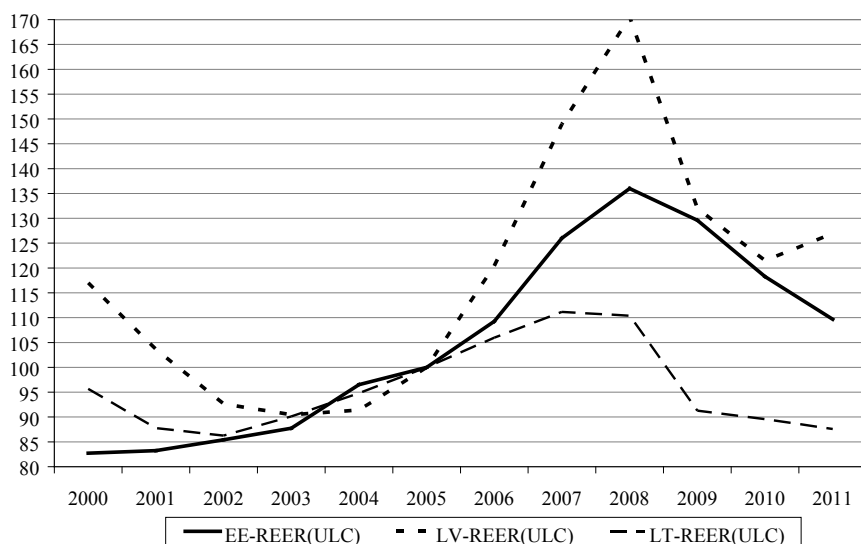
Source: DG-ECFIN AMECO (February 16, 2013).

Note: EE: Estonia; LV: Latvia; LT: Lithuania.

Analyzing the changes in the nominal effective exchange rate (NEER), the real effective exchange rate (REER), and the nominal unit labor cost (ULC, see Figure 5.9) by country, it is clear that the growth period of the Baltic EU membership of 2004–07 resulted in a measurable relative appreciation of Baltic production prices and costs. According to the NEER and the REER, the pegged rates were very unfavorable and disadvantageous for the Baltic region. Especially, in 2007, the REER sharply

appreciated, reflecting a price and wage increase. In the trends of Baltic ULC curves, all examined countries have been losing their wage competitiveness in comparison to the Eurozone. (Actually, mostly Germany has benefited from the trend of relative prices. See DG-ECFIN Price and Cost Competitiveness statistics.)

Figure 5.9. Annual real effective exchange rates vs. rest of the Eurozone, nominal unit labor cost, 2005=100.

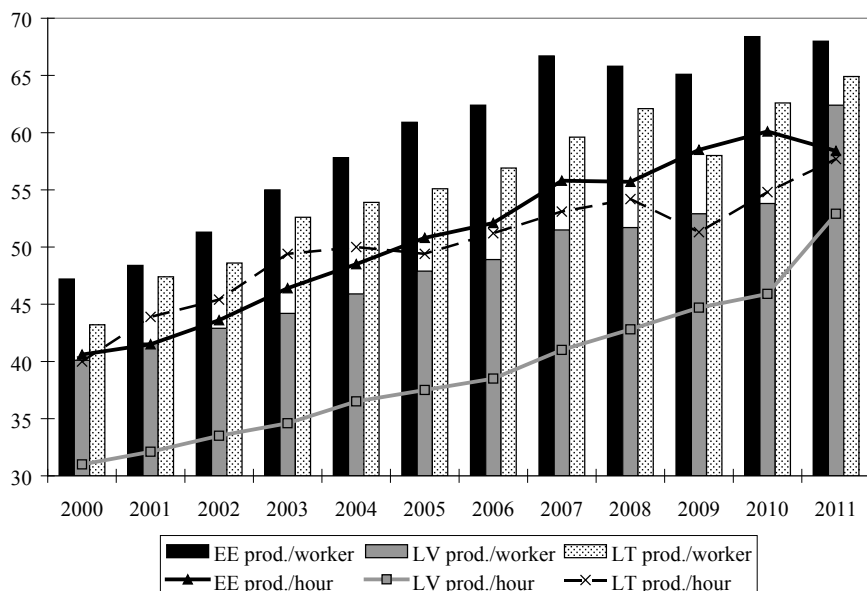


Source: DG-ECFIN Price and Cost Competitiveness (October 2012).

Note: EE: Estonia; LV: Latvia; LT: Lithuania; REER: real effective exchange rate based on the ULC.

Productivity can be used as a control indicator of real appreciation. As Figure 5.10 indicates, relative productivity deteriorated in the Baltics when a sudden stop appeared in the economic performance. In case of Estonia, relative productivity per worker significantly declined during 2007 and 2008, and the productivity per hour also experienced a slight decline in 2007. Lithuania also showed deterioration in 2009; meanwhile, the Lithuanian relative productivity per worker went through only a brief stagnation in period of 2007–08. These periods correlate with peaks in the ULC-based REER of Figure 5.9. These trends are what can be expected, as lower productivity increases the relative wage and this way the wage based exchange rate.

Figure 5.10. Baltic productivity per worker and per hour worked, EU average=100.



Source: Eurostat, TEC00116 and TEC00117 (May 17, 2013).

Note: EE: Estonia; LV: Latvia; LT: Lithuania.

5 Conclusions

In this study the political economy model of macroeconomic populism was represented through the case study of the Baltic countries. The model was supported with the economic theories of the Feldstein–Horioka puzzle and the reverse Balassa–Samuelson effect. As the results confirmed, the process of income growth and the quick catching-up of the Baltic economies were established on external financing. This phenomenon heated non-tradable inflation, as foreign savings were mostly channeled through credits and loans toward the household and corporate sectors. Finally, the external credibility of the region was exhausted independently from the global recession, but not independently from the global credit money shortage. This in turn caused a sudden stop, which demanded a quick and radical public and private adjustment in all of the surveyed countries.

It can be established that even an impressively catching-up economy with internal balance and with no heavy burden of public crowding out can fall into a recession or depression. The reasons for the slowing down of economic growth are many, such as the political motivations to heat the economy by leaving more room for the private sector to spend, the appreciation of real wage due to the fixed foreign exchange rate, the increasing inflation from sharply growing income, and the permanently growing external imbalance.

For all three Baltic countries, the signs and effects of passive macroeconomic populism can be detected, such as a balanced budget before the sudden stop, the pegged foreign exchange rate and the deteriorating external imbalance during the impressive growth period. It was also concluded that before the sudden stop, public indebtedness was low and stable. Meanwhile, private sector indebtedness was multiplied by the economic growth results. Inflation risk increased—except for Lithuania. The risk was increased by external indebtedness and the share of foreign currency in total debt. Importantly, all indicators of export competitiveness showed deterioration before the sudden stop. The NEER, the REERs based on the HICP and the ULC, and the terms of trade based on prices indicated an appreciation of costs and prices of the Baltic production. Namely, the economic indicators of the Baltics strengthened the assumption that national economic policies postponed those actions which could have sustained the export competitiveness and the relative cost of the regional workforce and production, even though the public finance and monetary indicators were kept in balance. This way, the inflation of prices and wage cost gradually terminated the attractiveness of Baltic investment opportunities and export products. Meanwhile, the sharply increasing income and creditworthiness of Baltic households had a negative impact on the current account by increasing import and on wage competitiveness by pushing the wages up first in the non-tradable, then later on in the tradable sectors.

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CHAPTER 6

Values, Norms, and Beliefs: The Case of Poland

Judit Kozenkow

1 Introduction

The Central and Eastern European region provides an excellent field for economists and political and social scientists to challenge the neoclassical theses. Based on the criticisms and deficiencies of these theses, scholars develop new methods and techniques to analyze the process of transition and highlight the significance of determinants other than basic neoclassical factors in economic development. Early studies and guidance from the World Bank and other Western organizations failed to generate successful results in most cases during the transition due to a lack of knowledge about the characteristics of the region's political, economic, and social environment. Further problems stemmed from handling these countries as a cohesive group (or with only minor classifications) and not analyzing their specificities.

Several new theories and empirical works have evolved since the 1970s and institutions have become increasingly important in explaining economic growth. New institutional economics (NIE) provides complex and detailed studies on institutions. Its analysis is openly interdisciplinary, recognizing insights from politics, sociology, psychology, and other sciences. Its explanations are based on individual decision-making (methodological individualism); its qualitative analyses are complemented by mathematical and statistical techniques. New institutional economics is an evolutionary theory that is based on an applied perspective and provides an open-minded, heterogeneous economic analysis (including in-depth case studies, historical analysis, econometric tests, experiments, modeling,

and so forth). Its empirical results provide convincing evidence on the impact of different institutions (formal and informal) on economic growth.

Poland provides an excellent example to apply this theory, because the country experienced stable economic growth between 1990 and 2010 and has provided one of the most successful economic performances among transition economies. However, public finances showed relative volatility with an average of 4.3 percent budget deficit and increasing debt ratio that remained still under the constitutional 60 percent of the GDP limit. This inconsistency in the macroeconomic data prompts us to search for the explanatory variables of the Polish economic performance by using new institutional economics and putting institutions into the focus of the research. Therefore, the present study aims to explain the relation between Poland's economic growth and its institutions, in particular formal institutions capturing public finances—fiscal control, executive power, and political stability—as well as informal institutions, i.e., values, norms, and beliefs.

The first part of the study highlights the main characteristics, definitions, and measurements of new institutional economic theory. It describes the core theoretical and empirical results that concentrate on the relationship between economic growth and institutions, and also stresses the main critical issues of new institutionalism. The second part provides an empirical study on Polish macroeconomic performance between 1990 and 2010. After a brief quantitative overview of economic growth, government balance, and debt, the chapter examines the public finances as formal institutions via a qualitative institutional analysis. Furthermore, the chapter provides a detailed description of Polish informal institutions, that is, values, norms, and beliefs. The conclusion defines the relationship between economic growth and the examined formal and informal institutions.

2 New institutional economics and its applications

New institutional economics is not an integrated theory but rather a combination of ideas coming from different fields of sciences. It is nevertheless built around a backbone of fundamental and original contributions proposed by Ronald Coase, Douglass North, and Oliver Williamson from the 1970s onwards. Together these contributions are not fully consistent. They are complementary in the sense that they fit together to compose a framework proposing a new way of analyzing economic phenomena (Brousseau and Glachant 2008). New institutional economics highlights the fact that instead of being constructed through a process of rational

choice and utility-maximization, society creates its own rationality by building a social order on the basis of the definition and reorganization of rights and rules. The latter permits collective action and empowers individuals; nevertheless, there is neither any specific end nor stable final state or equilibrium to be reached.

The main characteristics of new institutional economics can be described as follows:

- Economic, legal, political, and social institutions have important effects on economic performance.
- Institutions may be analyzed by using the rigorous theoretical and empirical methods of traditional neoclassical economy while complementing them with additional tools to better understand the development and role of institutions in affecting economic performance.
- Theoretical and empirical analysis should be interactive and complementary.
- The approach moves from general ideas concerning human agents, institutions, and the evolutionary nature of economic processes to specific ideas and theories (related to economic institutions or types of economy).
- Interdisciplinary research (contributions from history, law, psychology, anthropology, sociology, religion, and other related disciplines) may play an important role in advancing our understanding of institutions and their effects on the economy and the consequences of economic policies.
- Longer-term dynamic considerations associated with technological change and the diffusion of innovations plus the impacts of institutions on both of these should play a more central role in economic analysis.
- The understanding of institutions should be deep enough to allow the application of economic theory and empirical knowledge to a wide range of economic, cultural, and political settings.
- Although institutional analysis does not have a political agenda, it seeks to explain the role of government and political institutions in policy formation, implementation, and economic performance.

2.1 How are institutions defined and measured?

While the definition of institutions has a long history dating back to the early 18th century, new institutionalism after the 1970s has broadly accepted the description of Douglass North: "Institutions are the rules of the game in a society or more formally, are the humanly devised constraints

that shape human interactions” and they “are formed to reduce uncertainty in human exchange” (North 1990:3). Based on North’s classification, institutions are composed of “formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behavior, and self imposed codes of conduct), and the enforcement characteristics of both” (North 1992:6). Furthermore, the following categories can be most frequently found in the empirical literature:

- Formal economic institutions (security of contract and property rights, rule of law, dimensions of market efficiency);
- Formal political institutions (type of regimes, elections, constitutions, executive and legislative power, political rights);
- Informal/social institutions (religion, ethnic and historical background, civil liberties, civic communities, cultural values).

Different indicators capture the quality and development of the above categorized-institutions. Indexes measure the overall prosperity or competitiveness of countries (Global Competitiveness Index, Legatum Prosperity Index); reflect economic development (Index of Economic Freedom, Business Environment Risk Intelligence, International Country Risk Guide, EBRD transition indicators); others identify political or social characteristics (Freedom in the World, Eurobarometer, World Values Survey).

2.2 *Growth and institutions*

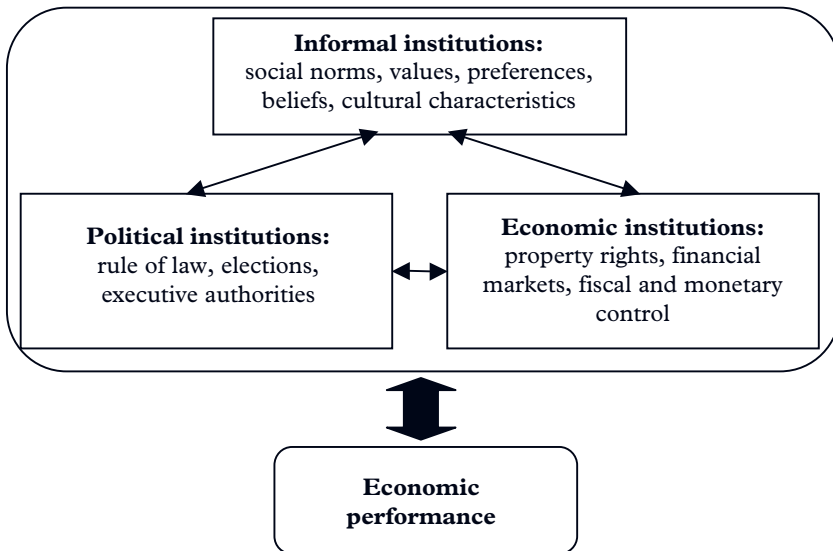
Based on the three major directions—economics of property rights that emphasizes *ex ante* institutional arrangements; transaction cost economics that stresses *ex post* governance; contract/agency theory that focuses on *ex ante* incentive alignments—, the literature on economic history, growth, and development within new institutional economics has been mostly defined and developed by North (1981, 1990, 2005), Williamson (2000), and Acemoglu et al. (2004). Over the years the focus of research has shifted from “do institutions matter?” to “how do institutions matter?”

North (1990) highlighted the deficiencies of neoclassical growth theories and the necessity of integrating institutions into economic analyses. He claimed that “institutions reduce uncertainty by providing a structure to everyday life. They are a guide to human interaction” (North 1990:3). In his view, formal and informal institutions influence economic performance through the reduction of transaction and production costs. Change in economic performance can occur due to either changes in relative prices or changes in human preferences and tastes.

Williamson (2000) identified four levels of social analysis—social embeddedness, formal institutional environment, governance of contractual relations, and resource allocation and employment—, and argued that higher levels of institutions impose constraints on the level immediately below. Change in lower levels of institutions or weak social performance is able to cause institutional change.

Acemoglu et al. (2004) emphasized the significance of economic and political institutions. In their model, economic institutions determine the incentives and constraints for the actors and shape economic performance. The development of economic institutions depends on the decisions of different interest groups and individuals. This indicates the dominance of the interests of the people with more political power. Political power is determined by the political institutions—*de jure* and *de facto*—and by the allocation of resources. Figure 6.1 illustrates the relationship between economic growth and institutions conducted from the findings of North, Williamson and Acemoglu et al.

Figure 6.1. Relationship between institutions and economic performance.



Source: own construction.

Empirical evidences on the role of institutions in economic outcomes have started to evolve in the last two decades with the analysis of formal institutions. Deeper analysis of informal institutions has begun in the 2000s with

the exception of a few early works. Several studies have determined to what extent the quality of public and private economic institutions, the particular structure of governance or the level of social capital may affect growth.

Political institutions as explanatory variables were first included in growth models by Barro (1991, 1996) and Clague (1997). The introduction of political stability as an institutional variable concluded that an instable political environment has a direct negative impact on growth and also affects it through the reduction of investments. The studies of Barro concluded that the formation and evolution of political regimes have been led by social characteristics (ethnic diversity, religious or colonial heritage, past growth performance). Acemoglu and Johnson (2005), Knack and Keefer (1995), Lane and Tornell (1999), and Mauro (1995) explained economic growth by studying different indicators of executive effectiveness. Their results showed a significant correlation between several variables of executive power and growth. Other studies confirmed that the rule of law has had a positive effect, while corruption has had a negative effect on growth. However, the findings of Aghion et al. (2004), Dobler (2009), Glaeser et al. (2004), Rodrik (1999), and others showed the effects of democracy, political instability, and other characteristics of political regimes in two different ways. Acting through various channels, democracy may have both positive and negative implications for growth;¹ political instability may reduce the volume and efficiency of investment and hamper growth; and revolutions and coups may influence growth negatively. Yet, these effects disappear when property rights are controlled.

Several studies concentrated on economic institutional variables. Barro (1991) and Acemoglu and Johnson (2005) found a strong negative relation between state-generated market biases and economic growth. Acemoglu and Johnson (2005), Knack and Keefer (1995), Pejovich (2003), and Rodrik et al. (2004) focused on contract enforcement and the security of property rights. They all presented strong pieces of evidence for the significant relation between economic institutions on the one hand and growth on the other, both directly and indirectly through investments. Clague and others (Aron 2000) proved the existence of a weak positive correlation of the development of the financial sector with growth as well as its strong correlation with investments.

¹ On the positive side, transparency and accountability may enhance economic and other rights. On the negative side, democratic consensus and interest group lobbies may delay responses to shocks and legislative decisions (Aron 2000).

Studies on social characteristics (informal institutions) appeared first in the work of Putman (1993) as well as in Knack and Keefer (1997). The latter scholars found that trust and civic norms have been positively associated with growth. Later results from Boettke et al. (2008), Helmke and Levitsky (2004), Pejovich (2003), Tabellini (2005), and Williamson (2009) supported the relationship of culture, norms, beliefs, and economic performance. Four informal institutional variables are undoubtedly identified, namely trust, respect, control over one's life, and obedience. The first three have a positive impact, while the latter has a negative impact on economic growth. Some of the scholars analyzed the arrangements among effective and ineffective formal and informal institutions by identifying four types: complementary, accommodating, substitutive, competing.

New institutional economics is generally criticized for three main deficiencies. First, the growth literature does not subscribe to one common definition and measurement of institutions, their processes of change, and the likely channels of their influence on economic growth. Second, there are a range of problems with data, methodology, and identification of variables. Although various studies establish statistically significant relationships between institutions and growth, they often forget to test the sensitivity of the results to different model specifications, reverse causality, and endogeneity between variables. Third, much of the cross-country empirical literature applies reduced-form growth regression models in which investment as a determinant of growth is replaced by a set of other variables that determine investment.² On the one hand, in many cases the set of variables determining investment is incomplete or contains other current endogenous variables, and on the other hand the different effects of institutions are conflated and it is difficult to distinguish their influence on growth (Aron 2000; Glaeser et al. 2004).

Nevertheless, taking into account the deficiencies in the institutional models, evidence for correlation and causation in the literature on growth and institutions is indisputable. Moreover, several studies have centered on correcting the above-mentioned problems with significant progress. Not only can we find evidence for the claim that "institutions matter" but we can also find explanations on "how institutions matter."

² Institutions exert indirect effects on growth through an increase in the volume of investment. Reduced-form growth regressions simply replace the investment variable with a set of institutional factors in the equation instead of using two different equations to capture the effects of institutions on investment, and the effects of investment on growth.

3 Economic development in Poland

This part of the chapter applies the above-described analytical methods of new institutional economics and studies the economic development path of a post-socialist country, Poland. It highlights the role of fiscal policies and governance as well as the influence of informal institutions in the Polish economic performance between 1990 and 2010.

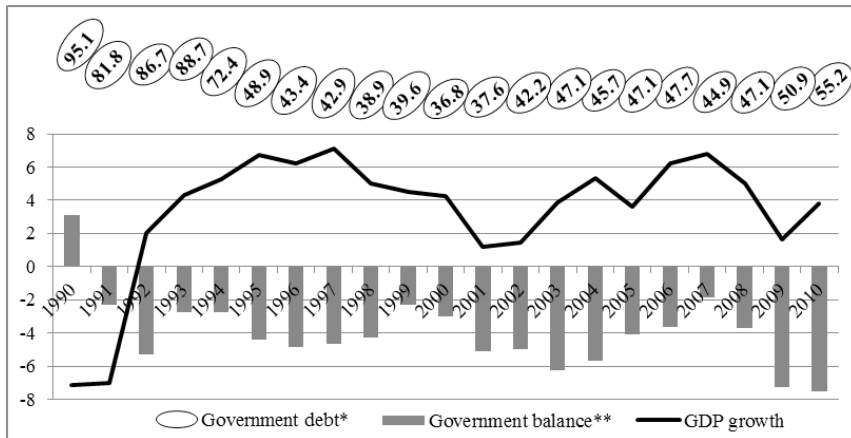
3.1 *Brief macroeconomic overview*

Figure 6.2 shows the Polish real GDP growth rates, the government budget balances, and government gross debt ratios between 1990 and 2010. In the beginning of its transition process, Poland experienced a deep recession (in Kornai's words a "transformational recession"), similarly to all the post-socialist countries in the Central and Eastern European region, but it recovered relatively fast and reached a positive growth rate again as early as 1992. During the 1990s Poland became one of the role models of a solid and consequent transition economy with high growth rates and ongoing reforms: macroeconomic stabilization, liberalization, privatization, and institution-building. Fear of overheating emerged after the middle of the decade, so government policies successfully slowed the economy that was also affected by a slowdown in the global economy in the millennium. The years after 2000 produced similar growth rates to the former decade, and Poland became the only country in the European Union that did not experience recession during the financial and economic crisis of 2008–09. Overall, the Polish economy grew by an average of 3.4 percent between 1990 and 2010 with a constant increase in per capita GDP (from \$6,000 to \$18,900).

Government finances, especially the budget balance, showed volatility over the studied period and a weak negative correlation with the GDP growth.³ Two consecutive agreements on debt-reduction in the early 1990s helped Poland decrease its debt (which was the highest in the post-socialist region), and from 95.1 percent it reached a record low of 36.8 percent in 2000. Then the remarkable trend turned and the debt constantly increased (55.2 percent in 2010) but remained below the threshold

³ $r(\text{debt})=-0.59$ and $r(\text{budget})=-0.44$

Figure 6.2. GDP growth and public finances in Poland, 1990–2010.



Source: IMF.

Notes: *Government gross debt in percentage of the GDP; **Government budget balance in percentage of the GDP.

of 60 percent of GDP. This threshold was included in the newly accepted constitution of Poland in 1997 as the maximum limit of government debt. The government budget experienced a positive balance in 1990, but the decline in output, costs of stabilization, structural reforms of the public sector, and disorder in bureaucracy and coordination easily turned the balance into negative terms during the following years. The deficit averaged 4.3 percent of GDP between 1991 and 2010. It showed significant increases before and during each election year. It reached a record high amount of around 7 percent due to crisis management and fiscal stimulus in 2009 and 2010.

While the debt-to-GDP relation appeared obvious, increase of budget deficits occurred simultaneously with an increase of the GDP growth rates. These relations can be explained in two ways. First, the solid Polish economic performance was not disrupted by the volatile budgets and overspendings of the governments, and the constitutional check on debt proved to be efficient in keeping the ratio under 60 percent of the GDP. The Polish economy does not depend on the short-term decisions of the political elite. Second, an increasing fiscal budget deficit can have a growth-generating effect through public and private spending. Finding the right explanations and driving factors requires a deeper analysis.

3.2 *Institutional analysis*

Macroeconomic data and quantitative analysis tell us little about the reasons behind economic performance. Neoclassical factors, studied by the IMF or Cernat (2006) and Havrylyshyn (2006), explain approximately 56 percent of the dependent variable in their growth models for Central and Eastern Europe. Other factors need to be studied and included in the analysis for a broader explanation. Therefore, the rest of the study concentrates exclusively on institutional factors as potential explanatory variables of growth based on the new institutional economic literature. To explain the Polish economic performance, institutional analysis provides a different, complex, and broad perspective. By analyzing formal and informal institutions, this theory searches for the roots of economic growth and helps us determine what institutions were shaping the Polish economic performance.

The study of public finances starts with an institutional analysis, which describes them qualitatively as fiscal control, executive power, or political stability. These factors are briefly summarized here, based on the analysis of the examined 20 years of Polish economic and political history.

Public finances can be explained as a formal economic institution: fiscal control proved to have a continuously decreasing influence on the Polish economic processes due to the implementation of macroeconomic stabilization, liberalization, privatization, and reforms of taxation. However, the size of state redistribution in Poland proved to be relatively high in an international comparison, due to the huge share of social expenditures and the high level of personal income taxes (OECD 2010). In the 1990s a consequent fiscal control was achieved in spite of the constant political debates, battles, and changes in governments. In the 2000s the implementation of fiscal reforms slowed down and the mounting deficit also started to generate problems.

Public finances can also be captured as formal political institutions, namely as the effectiveness of the executive authority and as political stability. The Polish executive power is characterized as a dual system, composed of the President and the Council of Ministers. The first decade after the transition can be characterized by continuous battles within the coalitions of actual governments and debates between the government and the president. The average ruling period of a government was less than one and a half years. After the millennium the political situation somewhat consolidated, but frequent changes in governments were still typical. The antagonism between the president and the governments significantly

reduced the effectiveness of decision-making. However, implementation of economic policy reforms were strongly and smoothly supported among rivaling politicians.

Surprisingly, the fiscal and executive mismanagement or government cycles were not reflected in the Polish economic processes and had no significant influence on the economic growth and development. This is also confirmed by quantitative institutional indicators and their correlation with the Polish real GDP growth rate between 1990 and 2010. Indexes of fiscal freedom and government spending of the Heritage Foundation declared Poland a “moderately free” economy, standing a bit higher above the world average. Indexes of government effectiveness and political stability from the World Governance Indicators reflected deteriorating effectiveness on the one hand, but improving stability on the other hand. Overall, none of these indexes showed significant correlation with the Polish GDP growth rate during the studied 20 years.⁴ These results are consistent with the qualitative description of the highlighted Polish formal institutions.

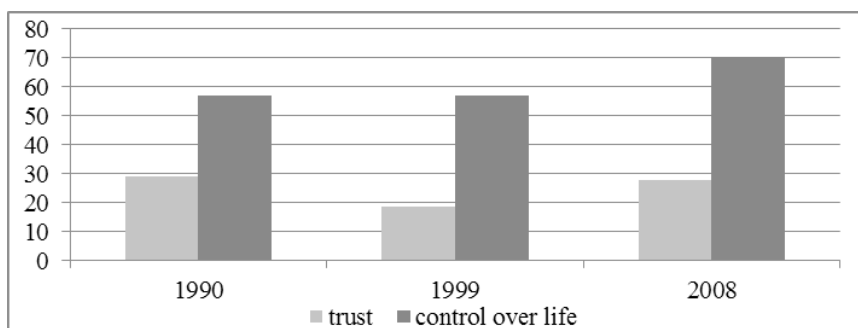
These conclusions suggest that the relatively independent economy of Poland must be determined by other factors. This chapter does not analyze other formal institutions, such as property rights, financial markets, monetary control, the electoral system, or rule of law, because even though these formal have proved to contribute positively to the Polish economic growth, the fundamental determinants can be identified among the informal institutional characteristics (Kozenkow 2012). This chapter stresses the relatively less explored field of new institutional economics and emphasizes the role of informal institutions—the foundations for formal institutions—to explain the above-described solid and exemplary economic performance of Poland, functioning independently from political and fiscal mistakes.

Informal institutions are “socially shared rules, usually unwritten, that are created, communicated and enforced outside of officially sanctioned channels” (Helmke and Levitsky 2004:727). To demonstrate the Polish social characteristics—informal beliefs, norms, and values—the European Values Study and World Values Survey have been relevant sources among institutional scholars. First, the four most researched informal values will be analyzed, namely trust, control and freedom over one’s life, respect and tolerance, and obedience, which have been confirmed to have an impact on economic growth. Other Polish social values that generally characterize

⁴ Detailed calculation and more explanation about the mentioned indexes can be found in Kozenkow (2012).

the society will also be examined. Figure 6.3 shows the level of trust in each other and the level of freedom and control over one's life.

Figure 6.3. Level of trust and control over life among Polish citizens in selected years.



Source: European Values Study.

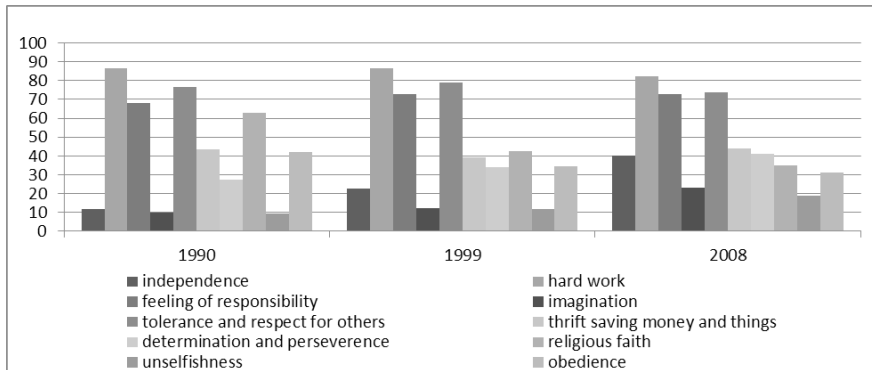
Note: Columns show what percentage of the respondents think that 1) most people can be trusted; and 2) they have control and freedom of choice in their lives.

The level of trust continued to be relatively low in Poland between 1990 and 2008 (last survey was conducted in 2008), but the Polish results are among the highest in the post-socialist region. However, trust as an informal social value is not considered to have a significant effect on the Polish economic growth. Nevertheless, the lack or a low level of trust among people can be compensated for or replaced by well-functioning formal institutions, primarily by secure property rights, contract enforcement and rule of law (Williamson 2009). This can also be strengthened by the willingness of the society to follow rules (norms).

In contrast to trust, citizens felt growing freedom and control over their choices in life during the years, and with a 70 percent of “free and self-controlled” citizens, Poland is one of the highest among the transition countries. According to institutional studies, the level of control positively contributes to economic growth. Other important social values of the Polish society are shown in Figure 6.4.

Tolerance and respect have been shown to generally have a positive impact on economic growth, while obedience is confirmed to affect growth negatively. From an economic viewpoint obedience restricts independence and trust in one's own abilities. Its importance has continuously shrunk during the past two decades and in 2008 it became one of the least important values. Therefore, its negative effect on growth could also decline.

Figure 6.4. Social values in Poland in selected years.



Source: *European Values Study*.

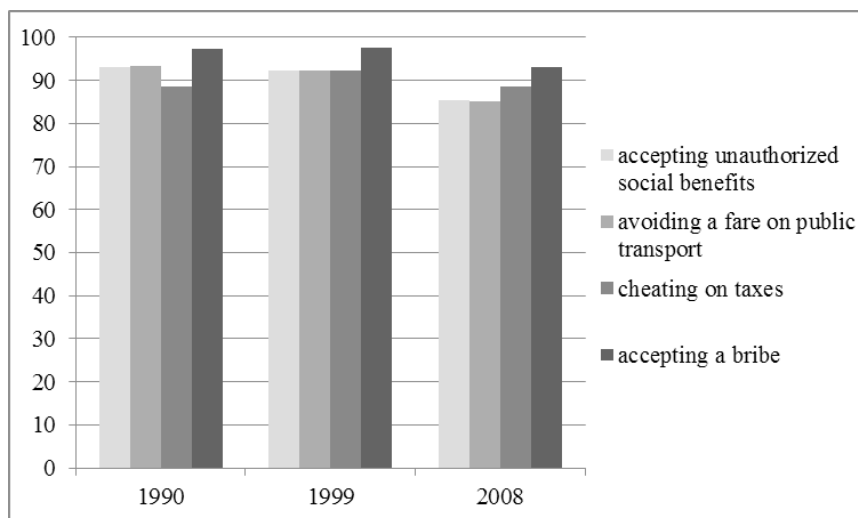
Note: Columns show what percentage of the respondents think of the specific value as an important one in their lives.

Although the lack of data series does not allow us to conduct econometric tests in the Polish case, it is obvious that tolerance and respect for others are among the most important values for Polish people, and, therefore, these values are able to compose the foundations of economic growth. Two further, highly important values in Polish society that complement tolerance and respect and are confirmed to have a positive relation with growth are hard work and the feeling of responsibility.

Social values in Poland that are highly represented in society, namely control over life, and respect and tolerance, have been shown to have a positive impact on economic growth. Hard work and the feeling of responsibility are also considered to be key values of employment and have growth-generating effects through increasing productivity and profits. Obedience as a “negative” value played only a little role in Poland. The only controversial value was trust, because its level among Poles was relatively low. Therefore, its growth-generating effect cannot be significant. Overall, the key values of the Polish society undoubtedly provide solid foundations for the country’s well-functioning economy and outstanding economic performance.

As it has been mentioned above, besides social values, norms are other useful guides to characterize a society, because informal institutions also shape formal institutional outcomes in a less visible way: by creating or strengthening incentives to comply with formal rules. Informal incentives are able to trump formal ones. Figure 6.5 illustrates the degree to

Figure 6.5. Unjustifiable activities in Polish society.



Source: European Values Study.

Note: Columns show the percentage of respondents who consider the described actions as unjustifiable.

which Polish society follows rules (formal ones). Four activities are highlighted here, namely acceptance of unauthorized state benefits, avoiding fares, tax evasion, and bribery. An extremely high percentage of Poles rejected all four activities; however, a slightly deteriorating trend appeared between 1990 and 2008, with the exception of the stable level of unjustifiable tax evasion. On average, 88 percent of society followed formal rules in 2008, while this level was 92 percent in 1990.

Beliefs of a society on the functioning of economy and politics, namely voter turnouts, interest in political decision-making, and other views on economic and political institutions can also help us demonstrate and explain the relationship between informal and formal institutions. While half of the Polish society was interested in politics in 1990, less than 40 percent of them showed an interest in 2008 (EVS 2011). This moderate interest in politics was confirmed by voter turnouts. The first, partly free elections were held in 1989, with a 62 percent turnout. During the post-socialist history of Poland, the average turnout at parliamentary elections was much lower; it fell to somewhere between 40–50 percent. Presidential elections attracted a bit more voters; generally more than 50

percent of voters appeared, with a record high of almost 70 percent in 1995 (IDEA 2011).

Generally, the low interest in politics among Poles can be explained by referring to the roundtable negotiations of 1989 and the liberalization, privatization, and institution-building processes of the 1990s. At the beginning of the transition process, representatives of the Polish society—the united opposition movement called Solidarity (*Solidarność*) and the Catholic Church—negotiated with the ruling Communist Party, and people felt that their interests were well represented in political talks and these also appeared in the final compromises. Major reforms of the political and economic system were implemented in the 1990s, creating a well-functioning framework, as well as an independent working class and a small- and medium-sized enterprise sector. Certainly, economic reforms were not completed in the 90s and political consolidation was also an ongoing process in the 2000s, but the foundations (the formal rules of the game) were created along people's needs and wishes (based on informal institutions).

Frequent changes in governments, as well as the stable and well-functioning economy independent from the state, also contributed to the Poles' low interest level in politics. This is confirmed by the enterprise and business survey of the World Bank and the European Bank for Reconstruction and Development in 1999, which showed that Poland had the lowest level of state intervention in the economy among the post-socialist countries, and which also positioned Poland positively in the developed world (on a scale of 100 Poland received 16.4 points) (EBRD 1999).⁵

Poles have been individualists: 88 percent supported the idea of emphasizing individuals, and more than half of the society preferred freedom over equality. They were in favor of competition (80 to 65 percent supported competitive markets over the examined years). These principles contributed to the well-managed economy and the minimal reliance on the state and the government. Confidence was generally low in different institutions, such as:

- the parliament—87 percent of the Poles had little or no confidence;
- the government—81 percent had little or no confidence;
- the social security system—61 percent had little or no confidence;
- and political parties—92 percent had little or no confidence in 2005 (WVS 2011).

⁵ BEEPS Surveys were conducted in 1999 to measure the size of state intervention in the economy on a scale of 100. The lower the point, the less the state intervenes (EBRD 1999).

The highlighted Polish values, norms, and beliefs undoubtedly point out a society with little interest in politics and definitely in favor of the principles of a free market economy. The study of Boettke et al. (2008) argue that informal institutions had a direct and an indirect impact on Polish economic performance. They explain Polish economic success with the functioning of private enterprises and non-collectivized agriculture during the Soviet era. Although the private sector composed only a minimal share of the economy and agricultural production was inefficient, the existence of private property as an institution gave small businesses the opportunity to practice and form market-based connections. This ability and knowledge became an advantage after the transition and contributed to the success of privatization.

Informal institutions evolve slowly over time and provide the foundations for a country's economic performance. The characteristics of the Polish society—high level of respect and tolerance, hard work, responsibility, control, and freedom over their lives, willingness to follow the rules, the favoring of individualism and competition but a low interest in politics—describe the foundations of the successful Polish economic performance. These values, norms, and beliefs have been shown to impact economic growth positively, and Poland's case strengthens and develops these results by illustrating that informal institutions are able not only to complement but eliminate weak formal institutions.

4 Conclusion

This chapter aimed at describing the relationship among Polish economic growth, the country's public finances regarded as formal institutions (fiscal control, executive power, and political stability) and its informal institutions (values, norms, and beliefs) between 1990 and 2010. New institutional economics provided analytical methods and tools to study the economic performance of Poland from a broader and deeper perspective than neoclassical theory, by concentrating on institutions, the rules of the game in a society.

Within the period under analysis, macroeconomic data presented weak relations among volatile government budgets, the increasing government debt and the stable annual real GDP growth rates. Government balance averaged -4.3 percent. Government debt remained under the constitutional limit of 60 percent of GDP. Economic growth was on average 3.4 percent.

The qualitative analysis of public finances as formal institutions explained that in the 1990s a consequent fiscal control was achieved in

spite of the continuous battles within the coalitions of actual governments and debates between the government and the president. In the 2000s the political situation somewhat consolidated, but the implementation of fiscal reforms slowed down and mounting budget deficits started to evolve. During those 20 years antagonism between the president and the governments significantly reduced the effectiveness of decision-making; however, implementation of economic policy reforms were strongly and smoothly supported among rivaling politicians. The analysis of Polish informal institutions showed that growth-generating social values, such as control and freedom over one's life, respect, and tolerance for others, as well as hard work and responsibility were highly represented in society. A significant majority of Poles also followed rules (norms). They had only a minor interest and trust in politics and generally preferred individualism, competition and freedom.

Informal institutions create the foundations of economic performance and directly impact formal institutions. The social characteristics of Polish society that have proved to positively impact economic growth provided the relevant foundations for successful economic performance. Furthermore, these social characteristics, accompanied by a well-functioning economic system and a low level of state intervention, were able to eliminate the deteriorating effects of political debates and fiscal mismanagement.

Poland's institutional framework demonstrates the dominance of growth-generating social values, norms, and beliefs, as well as formal rules, the democratic institutions, and more importantly the independently functioning economic system that was formed along and strengthened by these social characteristics. Polish society, in favor of individualism, freedom, and competition, was able to create success in the economy and distance itself from politics. Besides an independent economic system, political stability and fiscal policies had minimal or no impact at all on Polish economic growth. The successful Polish economic performance was fundamentally determined by the informal institutions and their compatibility with formal institutions.

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CHAPTER 7

Critical Junctures and Unintended Consequences: The Case of Hungary

István Benczes

1 Introduction

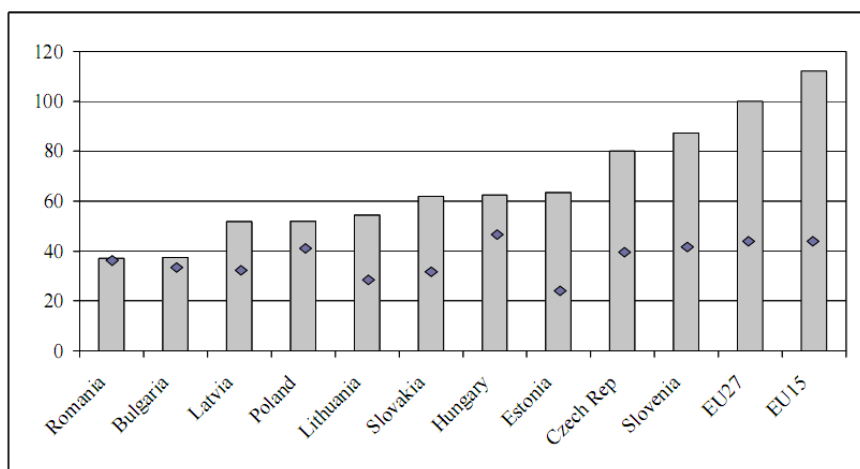
Hungary has been subject to “excessive deficit procedure” right after its accession to the European Union. The country was not able to reduce its public deficit below 3 percent until 2013 and was also unsuccessful in lowering its debt-to-GDP ratio to the 60 percent reference value (its ratio was slightly above 80 percent). The bias for persistent overspending has been coupled with an oversized general government¹ and, more recently, a stagnating economic activity.² That is, the economic troubles and challenges of the one-time forerunner of economic transformation have evidently gone out of bounds. While almost each new EU member state managed to close the gap in economic development between the EU average and itself after joining the union (by experiencing a roughly 2 to 3 percent positive growth differential *vis-à-vis* the old member states), Hungary has not succeeded in catching up. At the end of 2012 it still stood at cca. 60 percent of the

¹ In 2008, when the global financial and economic crisis erupted, the ratio of public spending to GDP was at 50 percent in Hungary. This ratio is characteristic of the welfare states of the Scandinavian states or France, countries with at least twice as high levels of development in terms of GDP (on purchasing power parity or PPP) than Hungary.

² The annual economic growth rate declined from 4.8 percent in 2004, the year of accession, to 0.1 in 2007 (the year before the crisis) and to -6.8 in 2009. While most of the CEE countries managed to achieve a positive growth rate by the end of 2012, Hungary was still in recession with a -1.7 percent growth rate (European Commission 2012).

EU15's average (on PPP)—similarly to 2004, the year of its EU accession, see Figure 7.1.

Figure 7.1. GDP versus redistribution in CEE.



Source: Eurostat (2013).

Notes: Bar: GDP per capita on PPP (EU27=100) in 2012. Diamond: total expenditure of the general government; data are averages between 2004 (the first year in the EU) and 2007 (the last year before the eruption of the global economic crisis).

It would be highly misleading, however, to come to the conclusion that the unpleasant economic tendencies have been triggered by either the EU accession or the more recent financial and economic crisis. Most analysts claim, instead, that the seemingly irreversible deteriorating trends have started in 2001 and 2002, when party politics along with election economics pushed the country onto an unsustainable path of development for good.³ Contrary to this opinion, this study argues that Hungary has always had serious troubles with keeping its public finances on track. Budgetary overspending, huge internal and external debt, and stop-go policy cycles characterized both Hungary's postcommunist era (right from the beginning of the systemic change of 1989–90) and its socialist past—a phenomenon that was rather unique in the communist world. The chapter argues accordingly that Hungary's persistent deficit and the high level of indebtedness presents nothing new in the country's history. A strong tendency

³ See especially Csaba (2011), Greskovits (2006), or Györfy (2006).

for deficit and debt, along with a hugely distorted structure of general government, have been the permanent features of the country in at least the past 50 years.

Questions that this study would like to address, therefore, are more complex than simply asking why Hungary has not been able to accommodate its general budget balance to the reference value of the Maastricht Treaty or the Stability and Growth Pact upon joining the EU. Putting the analysis into a historical perspective, the chapter raises the following questions instead: When did the negative tendencies in public budgeting originate and why? Why did the systemic change not bring about a new beginning (or at least a “branching point”) in the area of public finances? How is it that Hungary, a country which was once famous for its reform strategies (becoming the archetype of market socialism), seems to seriously and irreversibly lag behind almost all other EU new member states by now?⁴

As time and especially the sequence of historical events seem to play a crucial role in explaining the above puzzles in Hungary’s economic development and public finances in both the communist and postcommunist era, the current study applies the conceptual and methodological framework of historical institutionalism (HI). What makes historical institutionalism different from other new institutionalist approaches, such as rational choice institutionalism or sociological institutionalism, is its deliberate attentiveness to time (Hall and Taylor 1996). For HI analysts, history can effectively shape policy space and constrain the actions of political and economic players.

Although most studies in historical institutionalism applies a comparative perspective, the current study offers a one-country macro-context analysis (a case study) by pointing out the critical junctures in Hungary’s communist and postcommunist past on the one hand (concentrating on the period between 1956 and 2006), and by identifying the path-dependent character of the evolution of its policies, especially microeconomic restructuring and public budgeting on the other hand. The main hypothesis of the study is that the reform success of the country in terms of marketization and liberalization, which started in 1968 and made Hungary the archetype of gradualist reform in the socialist bloc,⁵ came at the price of

⁴ In a cluster analysis on governance, Benczes and Rezessy (2013) showed that by 2010–11 Hungary became the worst-performing country in the group of the Visegrád fours.

⁵ There exists an extensive literature on the Hungarian gradualist model. See for instance Csaba (1995), Kornai (1992a), or Kozminski (2008).

a preborn welfare state which caused public finances to deteriorate on a permanent basis.⁶ In more technical terms: the hardening of the budget constraint of the microeconomy came at the cost of the softening of the budget constraint of the general government (Benczes 2011). This study thus attempts to identify the main reasons behind Hungarian policy-makers' reluctance to consolidate public finances both before and after the systemic change of 1989–90. It is argued here that both the non-democratic, repressive communist regime and the democratically elected post-communist governments used the general budget as a buffer to compensate losers of (micro)economic reforms in the last fifty years or so. The hesitance to reform and consolidate public budgeting, however, soon culminated in deficit bias and an acceleration of indebtedness, which made stop-go policy cycles a permanent characteristic of Hungarian policy-making.

2 Why does history matter?

In neoclassical economics (and neoclassical political economy) time and space cannot affect the decisions of political and economic agents. Players unambiguously reveal their preferences and have a clear preference ordering. With the given set of constraints (such as income for instance), everyone tries to maximize their own utility (or happiness, satisfaction). Exogenously given institutions therefore have no other role in this process than defining the rules of the game to which rational individuals should accommodate their wishes and opportunities.

Historical institutionalism, on the other hand, takes both time and institutions very seriously. According to Steinmo (2008:150), “[h]istorical institutionalism is neither a particular theory nor a specific method. It is best understood as an *approach* to studying politics.”⁷ Its distinguishing characteristics as an approach are especially the sensitivity to big and relevant empirical questions and real political and economic issues which raise the attention of not just policy makers but also the wider public.⁸ Schol-

⁶ The term “preborn welfare state” was coined by Kornai (1992b). It might be reasonable, however, to refer to the Hungarian welfare regime as not only preborn but also premature.

⁷ Emphasis added.

⁸ Tilly (1984) explicitly defines the focus of the research program in the title of his book: *Big structures, large processes, and huge comparisons*.

arly work in HI tradition, therefore, focuses on “tracing processes through time,” with the general aim of analyzing “institutional configurations and contexts” (Pierson and Skocpol 1996:17).

As opposed to neoclassical economics, variables in HI are not considered to be independent from each other. Attentiveness to time means an explicit and distinguished interest in how one variable can interact with another one and, consequently, how the web of interdependent variables shape actions. According to Pierson and Skocpol (1996:12), HI “rarely focuses on a single institutional or organizational site of contestation, as rational choice scholars often do. Instead, they typically analyse how sets of organizations and institutions relate to each other and, in turn, shape the processes or outcomes of interest.” Consequently, the research program is not interested in the “big theory” and it is not searching for absolute, invariant or fixed laws.⁹

In the pluralist tradition of political science and economics, institutions have always been considered to be functional (i.e., a means to certain ends) or have been viewed as arenas for struggle amongst competing forces such as interest groups.¹⁰ For historical institutionalists, however, institutions are not neutral intermediaries; they are lively and dynamic

⁹ Some disclaims are in place here. On the one hand, HI’s interest in history is not the same as the interest of systems analysis or Braudel’s “long duration” theory, i.e., a slow-moving, “almost imperceptible” framework for historical analysis (Braudel 1973:22), because systems analysts are explicitly looking for the grand theory. HI is interested instead in real world outcomes and neglects theory—a point for which it is often criticized as atheoretical and deemed to be a non-scientific approach. On the other hand, some in HI such as Orren and Skowronek (2004), for instance, do explicitly aspire to building theory with a special attentiveness to historical processes.

¹⁰ The demand-side approaches of positive political economy are rooted in pluralist theories. In pluralist theories the dominant perception of politics is that the institutionalization of a permanent competition among actors can serve the interest of the general public (the nation) well. Compromise and conflict-resolution is an integrated part of political life, which also enhances general welfare. The steady competition of actors representing the interest of the entire political specter in the nation is a baseline of the democratic establishment. In fact, it is the struggle itself that makes it impossible for any (stable) group to grasp power for a longer time and to impose their will on the minority permanently. In pluralists’ arguments the state is not more than an arena which guarantees the framework for the permanent struggle among various groups and for a “place” to resolve conflict among each other (Killick 1976:176). Public policy (the dependent variable in political economy) is the result of such a complex net of competition, conflict and compromise.

forces which structure the political and economic struggles. Connecting time to institutional analysis implies therefore that “political battles are [not simply] fought inside institutions [but also] over the design of *future* institutions” Steinmo (2001:2).¹¹ Thus, institutions are endogenous, products of struggle among groups with differing preferences. Accordingly, not only do institutions shape strategies, preferences and outcomes, but they are also the outcome of either deliberate or unintended choices (Thelen and Steinmo 1992). Time, therefore, allows both policy outcomes and the distribution of resources to provide feedback on the evolution of institutions themselves (Acemoglu et al. 2005).

Importantly, the state cannot be considered anymore as “a neutral broker among competing interests but as complex of institutions capable of structuring the character and outcomes of group conflict” (Hall and Taylor 1996:938).¹² Consequently, HI has succeeded in bringing the state back into social analysis (Skocpol 1985) by refuting the interpretation of the state as a benevolent agent.¹³ These are the reasons why the current chapter on Hungary has chosen historical institutionalism as its main conceptual framework for analysis.

3 How to apply HI to the economic transformation of CEE?

It has been already shown that historical institutionalism dedicates itself to the study of “big issues” which seem to be relevant from an empirical point of view. Its macroscopic analysis, together with its attentiveness to time, allows scholars to concentrate not just on the interconnectedness and combined effects of institutions and processes but also on the emergence and evolution of these processes through time.

As HI is concerned about the big events, changes such as the fall and transformation of regimes, the origin and evolution of the modern state,

¹¹ Emphasis added.

¹² In the pluralist tradition, the state can be best described as a kind of transfer state. It reacts passively to the impulses coming from the outside (e.g., from different society-centered pressure groups).

¹³ A benevolent state means a functional, instrumental agent which acts on behalf of the society exclusively. It pursues the traditional functions laid down in welfare economics in order to remedy market failures—enforcing property rights, providing public goods, curing externalities, regulating monopolies, etc. In fact, a benevolent state is able to identify and implement first best policies (Findlay 1991).

the patterns of the welfare state, or the dynamism of public policies are the most often studied areas of research (see especially Collier and Collier 1991 on Latin America; Katzenstein 1974 on welfare states; or Pierson 1996 on the EU). Due to its relative success, HI has been applied to the study of economic and political transformation of the former socialist countries as well (see especially Bruszt and Stark 1998; Haggard and Kaufmann 1995; or more recently Bohle and Greskovits 2012). One of the major benefits of HI's perspective in relation to the analysis of CEE transformation has been the recognition that it was naïve to think that a quick and painless change could transform all these economies into a definite end-point, i.e., Western capitalism. By now it is clear that not only are CEE countries most probably different in several respects from their Western counterparts, but they are also different with respect to one another.¹⁴ The advantage of applying a historical institutionalist perspective is exactly the sensitivity of HI to varieties which play out through time. By concentrating on institutions which structure interactions, HI helps to understand why divergence in national trajectories exists. Accordingly, with the help of HI's main concepts, such as path dependency, critical junctures or unintended consequences, this study attempts to show that Hungary's changing position from the one-time forerunner to a laggard is not due to bad luck, but strongly related to the reform legacy of the communist past.

According to Pierson and Skocpol (1996:6), path dependence is "the dynamics of self-reinforcing or positive feedback processes" which can push a polity or economy "far down a particular path" and actors "are likely to find it very difficult to reverse course." Practically speaking, once decisions have been made, they can substantially constrain the set of available alternatives for the future. As time goes by, any change (such as a different track) becomes less and less attainable and more and more expensive. "Once a path is taken, then it can become locked in, as all the relevant actors adjust their strategies to accommodate the prevailing pattern" (Thelen 1999:385).

Originally, the concept of path dependence was conceived in relation to technological change describing a situation where the selection of one type of technology eliminated the other one—even if the alternative would

¹⁴ On this issue see especially the varieties of capitalism (VoC) school, which applies the conceptual framework and methodology of both analytical and historical institutionalism. See more on VoC and CEE in Chapter 4.

have proven to be more efficient. The technology-driven path dependence theory emphasizes randomness of choice (the starting point), the prevalence of increasing returns (practice can reduce unit costs), and irreversibility (increasing costs of change as time elapses). The result is a *status quo* bias for an inferior (or locked-in) technology.¹⁵ When transposing the concept from technology onto institutions, David (1994), one of the pioneers of technological path dependence, claimed that similarly to technology, institutions also evolve incrementally and over time, and are thus not necessarily Pareto improving. While originally North (1990:95) also linked path dependence directly to the prevalence of increasing returns, which is provided by a “web of institutional matrix”; later on he argued instead that history itself (along with institutions) explains the differences in national trajectories (see North 1994 and 1997). In the words of Hall and Taylor (1996:941): “[i]nstitutions are seen as relatively persistent features of the historical landscape and one of the central factors pushing historical development along a set of paths.”

As far as change is concerned, HI argues that substantial institutional changes emerge at times of shocks, economic crises or even military conflicts. These external events provide a kind of “critical juncture” or “branching point” from which a new path (or paths) can originate. For HI analysts therefore, time is divided into normal and critical periods. While no significant change can happen in normal times due to path dependency, critical junctures are the rare opportunities which can alter existing structures substantially (Gorges 2001).¹⁶

With regard to CEE, the systemic change of 1989–90 is most often assumed to be the critical juncture which opened up the way for radical political and economic changes in the one-time command economies.¹⁷ While the change itself was indeed a remarkable moment in time, a sort of branching point from which new paths did originate, it is only partially true in case of Hungary, which had started its long march towards market economy much before 1989. If a critical juncture is searched for

¹⁵ See the comprehensive review and assessment of Vincensini (2001).

¹⁶ Historical institutionalists are not the only ones to differentiate, however, between normal and critical times and to identify critical junctures as crucial in development. See for instance Acemoglu and Robinson (2012).

¹⁷ This time is often referred to as the window of opportunity (Balcerowicz 1995), i.e., a time when people were willing to take on a large burden in order to get rid of the old regime and to consolidate a new one where democratic political system goes hand in hand with market economy.

in Hungary, it is more likely to be 1956, the Hungarian revolution (exogenous shock) and the 1968 new economic mechanism. In the second part of this chapter, it will be shown that these two events have had far-reaching consequences (mostly unintended ones) for Hungary's postcommunist transformation.

4 Critical junctures in the socialist era of Hungary

The classical Stalinist regime existed for a relatively short period of time in Hungary. In the Stalinist regime, the maintenance of the political power of the communist party, along with Marxist-Leninist ideology, was underpinned by an almost complete nationalization of property rights. State ownership and bureaucratic coordination—together with the massive use of political repression and terror—provided a solid ground for forced industrialization. A rapid and extensive expansion of the heavy industries was supported at the cost of the light industry and agriculture and especially individual welfare.

The constant state of alertness for war and the extensive use of natural resources caused serious and constant shortages of consumer goods relatively early on. With the total depletion of national resources, surplus agricultural products, and cheap labor, the deficiencies of the classical command economy soon became overt everywhere in the socialist bloc. Reform in CEE, however, came only in the form of perfection of the command economy in most of the cases and did not touch upon any of the constitutive parts of the regimes. The only exception to this trend was Hungary, which turned to a rather unique national path of development by the mid-sixties. The anti-communist revolution of 1956 and the consequent possible threat of another social crisis and bloody uprising forced communist leaders to recognize the importance of meeting the material needs of the people. "The historical lesson of 1956 was that a socialist government should keep people satisfied in material respects and avoid periods of strong dissatisfaction" (Kornai 1982). The communist party elite, therefore, opted for the creation of an environment which endorsed relative political calm and material well-being. Public spending was redirected from physical investment to the material welfare of the citizens, thereby "incorporating individual consumer preferences and choices into the functioning of the economic system" (Bokros 2013:38). Thus, the revolt against communism and communist leaders in 1956 can be identified as a major shock (or branching point)

which altered the development path of the country and pushed it towards “goulash communism” later on.¹⁸

From the mid-sixties onwards, reforms with varying intensities were high on the agenda of Hungarian policy-makers. In December 1964, the Hungarian Socialist and Workers’ Party (HSWP or the Party) placed the whole economic mechanism of planning under serious criticism and established a working group of around 130 experts with the official mandate to find the ways and means for a more successful functioning of the economy. Official authorities were, however, reluctant to use the term “economic reform,” and used the expression of “reform of the economic mechanism.” Nevertheless, the so-called New Economic Mechanism (or simply NEM) encompassed a wide range of complex and systemic set of policies and institutions; thus, it is not misleading at all to use the terminology “economic reform” in relation to the changes of 1968. (See especially Radio Free Europe Research 1967.)

In rhetoric, the main objective of the first cycle of reforms (1968–73) was to increase the efficiency of the economy by introducing market incentives on the level of firms. Decentralization swept away mandatory output targets and input quotas. Economic decisions were delegated onto the level of factories. Managers were given more discretionary power. Indirect financial instruments were introduced in order to influence the behavior of enterprises. The strengthening of market incentives seemed to pay out relatively soon: reform brought about accelerated growth, which fuelled the improvement of individuals’ living standards as well. With its success, the New Economic Mechanism made Hungarian national trajectory unequivocally different from the rest of the Eastern bloc countries (Hare 1983).

Whatever merits the NEM had, the ultimate goal of the Party elite was not increased economic efficiency *per se*. The decision to move towards marketization was determined solely by political considerations. By providing additional economic growth and prosperity for families, party leaders of the HSWP wanted to stabilize their political power. The new trajectory soon became the archetype of a kind of “consumption-oriented” socialism, which favored individuals’ welfare as opposed to forced savings and industrialization. The NEM can be best interpreted as an implicit agreement between the citizens on the one hand and the communist Party on the other hand: in exchange for the relatively high standard of living

¹⁸ Importantly, the first reactions to the 1956 revolution were, however, brutal imprisonments and executions.

and the relative freedom (hence the term “the happiest barrack”), citizens did not question the leading role of the Party and did not demand more political freedom.

The success was, however, relatively short-lived. The first oil crisis of 1973 caused severe structural tensions in the country. Additionally, internal factors also contributed to the failure of the New Economic Mechanism: the genetic program (Kornai 1992a) of the communist regime did not allow for market reforms to push the Hungarian economy into the state of a new and stable, high-growth equilibrium. Bureaucratic intervention did not decline in practice, but rather it was replaced by indirect bureaucratic management. The change occurred in form only, and left the intensity of economic dependence untouched. Under NEM, quasi-market incentives were assumed to induce real competitiveness among firms. In practice, however, enterprises started to bargain with the different levels of bureaucracy for additional resources. Economic agents did not negotiate over the mandatory targets anymore; instead, they looked for favoritism in terms of economic regulations in the area of credit, tax, or subsidy.

The economic slowdown caused a major concern for Party leaders who wished to avoid political turmoil and insisted on further increasing the well-being of citizens.¹⁹ By the end of the seventies the gap between communist ideology and harsh reality became evident almost everywhere in the Soviet bloc: the Soviet model was not deemed to be superior to capitalism anymore. Intense shortage of basic staples and food became one of the main characteristics of command economy. The only exception was Hungary, where the material well-being of citizens was still high on the political agenda. Party elites, therefore, turned to external sources in order to finance consumption, which soon culminated in accelerated foreign debt levels.

All these negative trends of the seventies pushed the Hungarian economy towards a second reform cycle by the early eighties. The most significant elements of the reform steps were the following: informal activities (often called “second economies”) were legalized; small private firms (mostly in the service sector) were officially recognized; corporations could enter the financial market by issuing bonds; a two-tier banking system

¹⁹ Whereas Hungary grew at an average of 3.4 percent between 1961 and 1970, it slowed down to 2.6 percent in the seventies, and then to -0.1 percent between 1981 and 1988 (Kornai 1992a).

and a new, market-conform tax system were introduced; etc. The official aim of the second reform cycle was to restore the competitiveness of the country. The real aim was, however, more practical and could be derived from the objective of consumption maximization. Party elites wanted to maintain the relative well-being of families, which meant that private sector initiatives were not simply tolerated but also encouraged.

A major difference of the two reform cycles was the following. While the sixties saw the change of the incentive structure of large state enterprises and cooperatives, the eighties witnessed newly established private firms and services springing into existence. The further marketization of large, state-owned enterprises was not enough anymore to revitalize the economy. Instead, by the mid-80s more than 10,000 small new enterprises ("petty cooperatives" or "independent contract work associations") were established, in contrast to less than 1,000 state and cooperative enterprises (Bauer 1988).

In a HI perspective it is reasonable to claim that market reforms from the early eighties onwards were adopted from necessity (or as unintended consequences of earlier political decisions to maintain relative well-being), with the explicit aim of avoiding further economic deterioration. Since marketization significantly increased individual-specific uncertainty,²⁰ the state did not hesitate to embark on generous welfare programs. Thereby, the short-sighted state elites became able to compensate the losers of economic reforms. Compensations, however, soon became (universal) entitlements, which all added up and culminated in a unique welfare regime best characterized by the term "welfare state." With market incentives and private property on the one hand and an ever-increasing welfare state on the other hand, pragmatist Party-leaders provided a credible commitment to both market reform (favoring winners) and compensation schemes (placating losers).²¹

Needless to say, the model of the welfare state was not unique to Hungary; it existed in all the socialist countries. When it comes to the definition of a socialist welfare state, it is the free health care services, education and pension what most analysts identify as constitutive elements of such a state. What made Hungary and its welfare state regime unique,

²⁰ Aggregate-level uncertainty increased as well.

²¹ By 1981, Hungary's public expenditure (measured to the GDP) significantly exceeded other socialist countries' data: 63.2 versus 53.2 in Poland, 53.1 in Czechoslovakia, 47.1 in the Soviet Union, and 43.5 in Romania (Kornai 1992a).

however, was the persistently increasing share of income that people earned from transfers (and not just in kind but also in cash) on the one hand (see Table 7.1) and financing all these extra incomes from foreign debt on the other hand.

Table 7.1. Disaggregating personal income.

Year	Income from work	Social benefits in cash	Social benefits in kind	Income from other sources
1960	80.4	7.0	11.4	1.2
1970	76.1	11.3	11.3	1.3
1975	71.5	15.5	11.7	1.3
1980	68.0	18.9	13.1	0.1
1985	65.6	19.9	14.1	0.4
1990	58.1	22.6	16.6	2.7

Source: Kornai (1997).

While the general characteristics of the welfare states such as free education and health care were the result of cautious design, this was hardly the case with welfare transfers, which served to maintain the relative well-being of citizens mostly in terms of consumption. The emergence of such a unique welfare state with strong commitment to household transfers can be best understood as the unintended consequence of marketization and liberalization of the market socialist era.

5 Living with the legacy of the past: Postcommunism in Hungary

At the very start of the new democratic regime, the freely elected political forces tried to implement a series of painful reforms with the explicit aim of hardening the budget constraint of firms and individuals. The Hungarian bankruptcy law for instance liquidated insolvent capacities mercilessly, causing an immediate and drastic fall in economic activity. Hardening the budget constraint of enterprises came at a high price, however. Transformational recession totaled at 18 percent of the GDP by 1993, and Hungary experienced the most dramatic fall in employment in turn in the region. Adopting the 1989 level as 100 percent, employment declined first to 87 percent by 1991 and then further down to 72 percent by 1994. The numbers for the same period were 90 and 85.5 in Poland and 93.5 and 90.5 in the Czech Republic. Unemployment reached double-digit

numbers in the first half of the nineties and peaked at 12 percent in Hungary (Basu et al. 2000).²²

Under socialism, guaranteed employment meant a solid safety net for families. The appearance of the second economy in the eighties also provided some extra income for Hungarians. After the systemic change, the loss of jobs in both the first and the second economy endangered the living standards of individuals and also the relative political calm. In principle, the transformational recession should have triggered a dramatic erosion in living standards and private consumption, which was not the case, however. Private consumption declined proportionally much less than other macro-economic variables, thereby giving a special path-dependent character to the Hungarian postcommunist transformation process—see Table 7.2.

Table 7.2. Gross domestic product and its components, 1989–94.

	GDP	Final consumption		Gross capital formation	
		Total	Of which: total household consumption	Total	Of which: fixed capital formation
1989	100	100	100	100	100
1990	96.5	97.3	96.4	95.5	93
1991	84.8	92.3	90.8	75.3	83.3
1992	82.3	92.7	90.8	60.1	81.2
1993	81.7	97.7	92.4	79.5	82.7
1994	84.2	95.4	92.4	95.1	93

Source: own calculations based on CSO (2007).

Note: The closing date was set to 1994 because one year later Hungary adopted an austerity package.

The taxi and lorry drivers' blockade against the price increase of petrol just after four months of the first free elections in 1990 was a warning signal for incumbents that people did not tolerate a decline in their personal wealth status. The threat of a rebellion made it clear that reform in the micro sphere could go further only if the government *compensated* citizens. To put it differently: the new democratically elected leaders recognized that the price for

²² The unemployment rate was even higher in Poland; it peaked at 16 percent. Unemployment in the Czech Republic reached only a very low level of 3.5 percent in the early years of transformation. Nevertheless, following the 1997 Czech crisis, it climbed to 8 percent.

microeconomic restructuring was the preservation of the relative well-being of citizens. Household transfers were expanded to an extent which could significantly counterbalance the negative consequences of output fall. The general budget was burdened by a dramatic extension of social entitlements in the form of unemployment benefits, family allowances, sick leaves, early retirement schemes, etc. While the number of active population declined from 5.22 million in 1989 to 4.54 million by 1994, the total number of pensioners and other beneficiaries increased from 2.42 million to 2.95 million. The monthly average number of families receiving family allowance increased from 1.37 million to 1.5 million in the same period (CSO 2007). Consequently, the hardening of the budget constraint of firms came at the softening of the budget constraint of the general government.

As the communists earlier purchased the loyalty of citizens by maximizing current consumption at the expense of the future, governments following the systemic change had to adopt a similar attitude. The difference by the time of the systemic change, however, was that the ultimate goal of increasing consumption was replaced by the goal of minimizing the loss in consumption. The impossibility of hardening the budget constraint of the general government made the earlier status quo dominant in the new regime, too. Individuals looked at their welfare subsidies as rightful compensations for the loss of their jobs. Due to a strong presence of past sentiments (or path dependency), there was a strong tendency to a high level of redistribution and overspending at a time when one of the major challenges of the country was to deconstruct the old and inefficient state structures.

To interpret the systemic change in the framework of HI, it can be safely claimed that the unintended long-term consequences of the New Economic Mechanism (providing a relatively generous living standard at any cost) seriously constrained the policy space of the newly elected post-communist government(s) and made it practically impossible for them to scale down the entitlements that were provided by the premature Hungarian welfare state. In fact, the Hungarian transformation elegantly demonstrates that “the long-term effects of institutional choices, which are frequently the most profound and interesting ones, should often be seen as the *by-products* of social processes rather than the realization of actors’ goals” (Pierson and Skocpol 1996:14).²³

The artificially high level of aggregate demand caused serious imbalances in both the internal and external positions of the country and culmi-

²³ Emphasis added.

nated almost in a crisis at the end of 1994.²⁴ The inaction of the Hungarian authorities on the one hand and the Mexican financial crisis of 1994–95 on the other hand made international financial investors reluctant to finance Hungary. In order to avert a crisis, a stabilization package was adopted in March 1995. The fundamental goal of the consolidation program was to remedy the disequilibria in both the foreign and the internal balances, thereby stopping the dangerous spiral of indebtedness, and consequently regaining the trust of foreign investors. While preserving the political calm was an eminent objective of both communist and postcommunist governments between 1968 and 1995, the austerity package reneged on it and made the restoration of economic stability the only valid goal of the time. This was the only time from 1968 onwards when stabilization was initiated without any compromise.

The package aimed at enforcing short-term stabilization and long-term sustainability at the same time. Besides the strict measures of demand contraction, it also tried to reduce universal social entitlements substantially, thereby breaking down the pre-born paternalist welfare state. With these measures, in the late nineties, it seemed that the twin objectives of a smooth real convergence and a relatively early EU accession were not impossible to achieve. The impressive results provided ample room for politicians to engage in further reforms of the general government, thereby laying the foundations for a stable macroeconomic performance in the first decade of the new millennium.

However, the change in orientation did not last too long. As soon as the direct threat of an economic collapse diminished, Hungarian politics regained its pre-crisis welfare-maximization character, disregarding the need for stability orientation. At first glance, the 1995 austerity package was a real branching point in Hungary's post-communist history. It seemed that the 1995 reforms were able to pave the way for a sustainable path of long-term development. However, the legacy of the previous 30 years soon eliminated the new, and not yet fully stable structures, which meant that

²⁴ The current account deficit peaked at 9.4 percent of the GDP in 1994, and as a corollary foreign debt jumped from \$13bn to \$18bn within two years, amounting to 45 percent of the GDP. As far as the internal disequilibrium is concerned, the general government deficit also reached unsustainable highs and the general government debt accumulated to nearly 90 percent of the GDP. The loosened fiscal policy was supplemented by a lax monetary policy, keeping benchmark interest rates so low that the real interest rate turned into negative, inducing households to keep their savings in foreign currency denominated assets (HNB 1996).

their reversal was easy to implement. Importantly, the 1995 reform did not manage to institutionalize its results (there was no such “Northian web” of reinforcing institutions which could have maintained the new status quo). Some parts of the package were deemed unconstitutional (mostly in relation to welfare provisions), while other parts were thrown out by incoming governments (both from the left and the right). Most importantly, its ideology of stability first and welfare second soon became untenable for both politicians (who wanted to become (re)elected to power) and citizens (who wished to be compensated for the losses of the 1995 package).²⁵

By 1999, the growth rate of private consumption exceeded once again the increase of overall economic activity, which was further deepened by the world-wide economic slowdown in 2001 and especially the rebirth of the political business cycle in 2002. The run-up to the 2002 elections dramatically accelerated public spending—mostly in the form of increased social entitlements. The right-wing coalition faced a head-to-head race with the main opposition party from the left and reacted with generous spending programs and promises. Incumbents targeted voters by a public sector wage rise and household transfer increase (EIU 2002). The Hungarian Socialist Party (HSP), the largest opposition party, responded in a similar tone, promising several welfare-improving measures in advance, especially in the form of tax cuts and wage/transfer increases. On the one hand, the socialists tried to differentiate themselves from the governing right-wing parties by claiming that extra revenues should be channeled back to the people in the form of tax reductions instead of spending the money on white elephants. On the other hand, the HSP also wished to clearly distance itself from the dark legacy of the 1995 austerity package which was adopted under a socialist-liberal government. With the promise of a “welfare regime change,” the HSP promised a substantial increase in families’ living standards by increasing the salary of teachers, health care workers, and young couples. Election economics pushed the two sides of the political arena into a vicious circle of untenable promises.

In the race of welfare demagoguery, employees in the public sector received a 50 percent hike in total between 2001 and 2003. The share of compensation of public sector employees to total outlays climbed to 25 percent by 2003 from the initial 20 percent in 2000 (OECD 2004). Family-related benefits were substantially increased and generous housing sub-

²⁵ Real wages were cut down by 12 percent on average as a result of the 1995 stabilization measures.

sidies were introduced. For pensioners, the so-called 13th month premium was introduced by 2002 in a country where 90 percent of the employees have been eligible to retire years earlier than the official retirement age. The generous welfare system, along with an outstandingly high tax wedge on employment, provided serious disincentives to work: only (a bit less than) four million out of the total seven million active people were registered employees in Hungary—and this ratio did not change later on either.²⁶

The period between 2001 and 2006 can be best characterized therefore as an irresponsible and permanent election campaign where both the incumbents and the opposition tried to outperform their rivals by promising more spending from the budget without keeping an eye on the financing constraint of their populist measures. In fact, “the stagnation of reforms and the deepening of mutual distrust among and across all players of the political scene have created a *paralysis*” (Csaba 2009:95). Following a relatively short period of success between 1996–2000, a new era emerged from the early 2000s onwards in Hungary. Antal, Csillag, and Mihályi (2005) defined this period as the time of neo-Kádárism (after the late first secretary of the HSWP, János Kádár), a term that reflected the rebirth of consumption-orientation. The expression also highlighted the return of expansionist state paternalism, along with the revitalization of the pre-mature welfare state, financed by increased deficit and debt.

Accordingly, it is reasonable to argue that one of the unintended consequences of the Hungarian pre-mature welfare state is that any reform in the general government was simply impossible both before and after the systemic change—due to the rising number and share of entitlements on the one hand and the increasing proportion of the population who could rely on the provisions of the unique welfare regime on the other. As a corollary, the legacy of the pre-born welfare state is very much alive and is still characteristic of the modern Hungarian capitalist state.

6 Conclusion

At the time of the political and economic change of 1989–90, Hungary was the forerunner of economic transformation. The country’s leading position was mostly due to its gradualist reform strategy which was adopted well before the systemic change. The apparent success in terms of

²⁶ See Benczes (2008) for details on welfare demagoguery between 2001 and 2006.

marketization, liberalization, and microeconomic restructuring during the years of market socialism, however, only masked the paralysis and inaction of the country in other fields, especially in public finances. Accordingly, this chapter tried to provide an answer to several questions, such as when and why these negative tendencies originated; why the country did not manage to capitalize on its reform experience following the systemic change; and how Hungary, a one-time forerunner, has become a laggard in the group of new EU member states.

By applying the conceptual framework of historical institutionalism, the chapter argued that Hungary's persistent deficit and huge debt is nothing new, as all of these have been present (at least) in the post-World War II history of the country. Although market socialism gave Hungarian socialism a distinctive feature, the introduction of market incentives on the level of the micro economy came at the expense of the softened budget constraint of the state. As a corollary, both communist and postcommunist governments used the general budget as a buffer to compensate losers of (micro)economic and political reforms through the last five decades.

The current chapter was also an attempt to show that early choices can have a serious and persistent effect thereafter, too. What made the country unique and distinguished for a relatively long period of time (i.e., reform socialism) pushed the country into a dead-lock under postcommunism. Through the example of Hungary, the chapter showed that institutions cannot be considered as neutral intermediaries. They are in fact able to structure the political and economic struggles and can do more harm than good.

Last but not least, the Hungarian case study contributed to a better understanding of transformation as a process as well. The chapter underlined what Chavance (2002:54) formulated in the following way: "To draw some 'general lessons' from the transformation process [...] the challenge of diversity has to be faced, and inductive analysis of the variety of national experiences to be done. If not, the risk will be important, to wrongly generalise one specific or partial experience, or period, without dealing with historical specificity as a necessary component of general theorisation."

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CHAPTER 8

Structural Reforms in a Low-Trust Environment: The Case of Slovakia

Dóra Györfly

1 Introduction

Lack of trust is a pervasive feature of post-socialism. The former regime was essentially built on distrust—at an interpersonal level loyalty to the party and the state was expected to take priority over loyalty even to friends and family, while citizens could hardly trust a state, which exercised terror and operated without checks and balances (Kornai 1992; Rose 2009). Building trust proved very difficult during the transition process as well (Sztompka 1996)—while the perceived corruption and moral injustice associated with the privatization process undermined trust in state institutions, the growing inequality hindered the building of interpersonal trust. Such tendencies are clearly shown by cross-country studies on the determinants of trust—post-communist countries tend to score lower on a wide range of measures associated with trust than countries without a communist heritage (Bjørnskov 2006; Traps 2009). This influence is present even in the former East Germany, which has been integrated into the institutional framework of the former West German system for over two decades (Rainer and Siedler 2009).

For the purposes of governance lacking institutional trust has serious consequences. Since the path-breaking works of Easton (1965) and Gamson (1968), political trust has been recognized to be necessary for accepting and complying with the decisions of authorities (Braithwaite 2009; Tyler 1998). Under such conditions it is unsurprising that at the time of transition there were widespread fears about the possibility to establish a Western type democracy and capitalism simultaneously (Offe and Preuss 1991).

In retrospect, it is clear that the task was not impossible. According to Bohle and Greskovits (2012), identity politics in the new states and welfare

provisions in the Visegrád countries allowed the regimes to raise support for the transition process. After these resources were exhausted, the perspective of EU accession provided the anchor. At the same time it is also clear that the possibility of overcoming the obstacle presented by distrust does not imply the irrelevance of trust. Following accession to the EU reforms clearly slowed down as manifested by the inability of the majority of the new member states to introduce the common currency (Csaba 2009:87–116).

Starting from a seemingly disadvantaged position Slovakia managed to cope not only with the task of introducing the euro but—given its wide-ranging market reforms during the 2000s—it is also among the few countries which have returned to a steady growth path following the crisis. Its experience naturally breeds the question: how was it able to surpass the unfavorable conditions of post-communism and implement reforms which proved to be overly challenging to the majority of the region?

In order to answer the question, first a discussion of the precise mechanisms through which distrust reduces the likelihood and credibility of reforms is provided. Then comes an overview of the Slovakian structural reforms with an emphasis on public finance. Finally, it is examined what made these reforms possible and how the impediments imposed by distrust were overcome.

2 The relevance of trust for policy-making

2.1 *Trust and the time-horizon of decisions*

In order to uncover the consequences of distrust for policy-making, first it is important to look at what trust means. In an attempt to provide a cross-disciplinary understanding of trust, Rousseau et al. (1998:395) defines trust as “a psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behavior of another.” This implies that when acting upon trust we cannot be certain that the other party will not abuse this trust.

Lack of certainty does not mean that trust implies blind faith. When accepting vulnerability the actor uses the information available on the other party. In this sense there are rational elements of trust such as experiences from past interactions or the understanding of the motives of the other party. However, it is also important that the picture is necessarily subjective, since no one can be certain that he or she knows all the relevant facts about the other party's motives. This makes belief an essential ingredient of trust, which facilitates action on the basis of incomplete information (Möllering 2001).

The social science literature distinguishes between particular and general trust (Uslaner 1999:126–7). Particular trust means that people trust only those who are part of the same community—such as family members or those with the same religious faith. This kind of trust is based on personal knowledge, the necessity of repeated cooperation, and shared identity which reduce the danger of an abuse of trust. In contrast, generalized trust means that most people, including those outside one's social group, can be trusted. As society became larger and more complex, this kind of trust gained increased significance, since this makes cooperation among strangers possible. From the perspective of aggregate economic outcomes, it is generalized trust that matters, since this form of trust makes anonymous exchange possible.

The written and unwritten rules of society contribute to generalized trust and increase the predictability of interactions among members. According to Offe (1999:73–5), institutions can generate trust through enforcing the values truth-telling, promise-keeping, fairness, and solidarity, which contribute to trust. Such an outcome is not the result of a single institution but rather the joint effect of a set of institutions. Truth-telling and the provision of information are ensured for example by the freedom of the press, public court proceedings, and accounting standards. Promises are enforced by contracts and independent courts. Equality before the law and equal political rights foster a sense of fairness. Finally, state redistribution towards the less fortunate generates the feeling of solidarity. The success of institutions in these endeavors can give rise to *moralistic trust* which claims in a normative sense that most people should be trusted. This is a variety of the Golden Rule, which requires “you do unto others as you would have them do unto you” (Uslaner 2008:103). Not attributing the intention of exploiting trust to the other party follows from this rule. According to Uslaner (2008:117), moralistic trust is the real foundation for generalized trust.

The importance of institutions generating trust underlines the fact that in everyday life governance, which is the output side of the political system, is at least as important as the input side, elections. In the absence of good governance¹ generalized trust cannot emerge and the institutions cannot fulfill their role in coordinating the interactions of citizens. If the

¹ The concept of good governance became widespread following the failure of the neoliberal agenda about minimizing the role of the state. It is generally defined in terms of respect for democracy, human rights, rule of law, as well as transparent and efficient state administration. For a more thorough overview about the concept, see Weiss (2000) and Rothstein and Teorell (2008).

state is widely seen as corrupt, there is no equality before the law and public services increase rather than decrease life opportunities, the non-privileged groups are unlikely to have strong motives to respect the rules.²

The above consideration is particularly important once we recognize that in the emergence of rule-following behavior the legitimacy of norm or its creator is particularly important. In his overview about rule compliance, Hurd (1999) differentiates three different motives for following the law: coercion, self-interest and the legitimacy of the rule. He claims that the most efficient is the third, when internal convictions rather than external pressure create obedience. Physical coercion is not only expensive but also leads to resentment and resistance to the law and authorities (pp. 384–5). Self-interest is somewhat better in motivating voluntary compliance, but in the long-term it is likely to fail since it encourages continuous cost-benefit analysis about following the rule—once it appears to be costly, there seem to be no reason to obey.³ In contrast, rule compliance based on legitimacy does not calculate and obedience becomes habitual—in this case breaking the rule has psychological cost and thus requires special consideration (p. 388). If this is missing and following the rules is not in someone's interest, rule-avoidance becomes the norm since it is clear that the state cannot have a policeman for every citizen.

Based on the above it is clear that institutional trust has a particularly important function in the creating generalized trust. Without institutional trust the risks of cooperating with strangers increase greatly. If business partners cannot be certain that contracts are enforced, they will require much more guarantee for signing a contract than in an environment where respecting the rules is the norm. This not only increases transaction costs, but it also results in an uncertain, unpredictable environment, where long-term plans are unrealistic. It is very risky to invest in a place where

² A good example for this idea is provided by the research of Hellman and Kaufmann (2004). Based on data from 6,500 companies in 26 transition countries, they find that those firms which feel that they have disproportionately small influence on regulations directly affecting them have a negative view about public institutions, are less likely to pay taxes, and are more likely to engage in corrupt practices. Paying taxes or paying bribes appear to be substitutes.

³ It is important to note that Hurd (1999:386) does not accept references to enlightened self-interest, since if everything can be considered self-interest, then the concept becomes empty. In his definition of self-interest, the individual does not accept moral responsibility for others, which means that her relations are purely instrumental. This does not exclude cooperation, but it does imply that the relationship in itself is not valued only the benefits it yields.

contracts are not enforced by independent courts and respect for private property rights cannot be taken for granted. In such an environment short-term survival becomes the major objective for those who cannot leave, and rule-breaking and corruption become a widely accepted means towards this objective.

In a low-trust environment the evasion of rules is generally fostered by perceptions about success. This has been analyzed empirically by Csepeli et al. (2004:222), who found that in contrast to Western Europe, in Eastern Europe perceptions on success are much less associated with talent and hard work than with dishonesty. If success is associated with rule-breaking and weak institutions are seen as unlikely to punish trespassers, people will have much less internal resistance to do the same, and a vicious cycle emerges among low trust, wide-spread rule-evasion, radical uncertainty, and short-term thinking.

Politicians, who expect to gain votes during elections, cannot remain impervious to the prevalence of the above cycles. Since long-term promises are not credible, in the absence of strong external pressure they answer to the short-term objectives of the citizens by short-term solutions in order to gain votes. These, however, rarely intersect with the requirements of sustainable development.

The possibilities for short-term solutions are almost endless. In the socialist system the state generally looked another way rather than punished trespassers. The leaders of the system attempted to reduce the social stress due to shortages and the resulting low level of consumption through allowing private deals very often involving the use of state resources. The state authorities were willing to overlook these dealings and show leniency, although it was unpredictable when they changed their mind and applied the law in its full rigor (Kornai 1992:451–2). While the second economy indeed improved the standards of living, it also implied a lasting heritage about the shared disregard of rules by both citizens and authorities.

Improved living standards can also be achieved by increasing public or private debt. In order to improve their popularity, democratic governments can increase spending or cut taxes—they both lead to budgetary imbalances, but while the first option generally benefits the poor, the second option benefits the tax-payers. If the rise in deficits is not feasible for any reason, loose financial regulation makes it possible to increase present consumption at the cost of the future without directly influencing state finances. The likely failure of the above strategies already at the medium-term further increases the distrust towards the institutions and strengthens the short-term orientation in society.

2.2 *The difficulties of reform*

The focus on the short term has particular significance for countries in need of structural reforms. As formulated by Easton (1965:273), a major advantage of public trust is to serve as “a reserve of support that enables a system to weather the many storms when outputs cannot be balanced off against inputs of demands.” This implies that when potentially difficult changes have to be made, the government is able to implement first-best measures, even if they might be painful for the population in the short term. In such a scenario, the perception of the public about the competence and integrity of the government makes the demands for sacrifice acceptable.

The problem of implementing real change in a low-trust environment comes from the lack of credibility in the promises of the government. If the citizens are accustomed to disappointment in the outcome of long-term plans, then promises about long-run benefits at the cost of short-run sacrifices are simply not credible. This problem can be exacerbated by the memory of previous outcomes: if citizens had experienced that governments were concerned only with their own short-term interests rather than the public good, it is unlikely that they presume different motives during the next campaign for change. Similarly, if they had seen that previous reforms resulted in very different outcomes than promised by the policy-makers, it is unlikely that they will believe in similar promises by later governments. This implies that in a low-trust environment, where citizens are disillusioned from the political process, it is very difficult to make credible promises and overcome the resistance to structural reforms.

Resistance against structural change might emerge from a variety of sources depending on whether the individual ultimately would gain or lose from the reforms. Those who permanently lose from the changes should be compensated from the gains to society; however, this promise is not credible from an untrustworthy administration. For those who stand to gain from the changes, the uncertainty of the future and the unreliability of the promises of the government maintain their resistance to change. These problems are summarized in Table 8.1.

The result of the above problems is that it is more likely that instead of fostering genuine change, policy-makers are likely to engage in a form of firefighting and find some quick fix solution for the most urgent matters without addressing the source of problems. These steps might be successful in the short term, but within a given period their insufficiency or

Table 8.1. Structural reforms: sources of resistance, solutions, and the role of credibility.

Source of resistance	Solution	Role of credibility
Permanent losers from market forces	Compensation from societal gains	Uncertainty over whether promised compensation will be forthcoming
Short-term losses but long-term gains with short-term preferences	Policies facilitating adaptation to the new environment	Uncertainty over long-term gains
Uncertainty over reform outcomes	Provision of information	Unreliability of information

Source: Györfy (2009:151).

the unintended consequences of solutions are likely to lead to the re-emergence of the problems.

2.3 Implications for fiscal consolidation

The above theoretical discussion on the difficulties of reforms can be illustrated by examining the problem of fiscal consolidations. This is an issue which democracies have to face regularly. The pressure to stabilize can emerge from a variety of sources including pressures from financial markets, demography, or an obligation from supranational institutions such as the EU. When designing the consolidation package, the government has several choices to decide upon. On the revenue side it can increase taxes in a distortionary or non-distortionary manner, while on the expenditure side it can reduce spending—deciding between productive and non-productive expenditures. An important element of successful and lasting consolidation is to institutionalize the commitment to responsibility to fiscal rules and also improve the efficiency of future decision-making. At the same time, the most successful method to consolidate is to improve the performance of the economy through increasing the efficiency of public services.

Based on the theoretical discussion on reforms it can be expected that in a low-trust environment the method of consolidation is likely to be sub-optimal—the primary motive in the decision over consolidation methods is likely to be a short-term political one rather than a long-term economic one. Short-term political perspective is likely to opt for raising taxes rather than cutting revenues—especially cash transfers, which are most visible for the public. If cutting expenditures, public investments might be targeted instead.

At the same time, it has been shown that the success of fiscal consolidation is strongly affected by the composition of adjustment.⁴ Addressing the experiences of Denmark and Ireland, Giavazzi and Pagano (1990) were the first to indicate that contrary to traditional Keynesian views, fiscal consolidation is not necessarily accompanied by a recession as the decline in aggregate demand might be countered by positive expectations concerning the future prospects of the economy. Alesina and Perotti (1995) pointed out that in achieving non-Keynesian effects, the composition of adjustment is critical—while successful consolidations are based on the reduction of government wage bill and social transfers, unsuccessful consolidations are primarily oriented towards raising taxes. Alesina et al. (1998) explained this finding by arguing that under the former type of adjustment, increasing investment and decreasing labor costs improve growth prospects, and thus offset the negative effects on growth due to a fall in demand. These results are also supported by Ardagna (2004), who shows that these factors play a significant role in the success of adjustments even after controlling for differences in growth rate, expansionary monetary policy, or the devaluation of the currency.

The above literature provides three major reasons why an expenditure-based consolidation can prove more successful than a revenue-based consolidation:

- 1) Cutting expenditures, which are politically difficult, send a signal about the commitment of the government to address the imbalances, which increases the credibility of the adjustment. Increased credibility leads to lower interest rates, which improves the fiscal balance in itself. In the case of increasing revenues, there is no such effect because an inefficient state cannot prevent the reemergence of imbalances even with more resources to redistribute.
- 2) Lower expenditures lead to expectations about lower future taxes, which increase profit opportunities and thus positively have positive effect on investment. Raising taxes have the opposite effect.
- 3) Restraints on government wages make it possible to restrain wages in the private sector, which increases cost-based competitiveness.

⁴ In the following, only a brief review of the literature on successful fiscal adjustments is provided. For a broader overview, see Benczes (2008).

Decreasing social transfers have a similar effect as it raises the incentives for taking employment. In contrast, when raising taxes, lower net incomes might trigger demands for gross wages or a decrease in the motivation for taking employment.

Besides the effects of composition, presence or absence of trust also has an implication for the commitment of sustaining responsibility. In a low-trust environment, given the political costs of stabilization, once external pressure eases, an effort to compensate the electorate for the austerity is likely to follow.

3 The case of Slovakia

In light of the theory, a major surprise of the transition is Slovakia, which succeeded in implementing far-reaching structural reforms during the 2000s and managed to introduce the euro—alone among the Visegrád countries. This performance was far from evident as disillusionment and distrust has been widespread in the country following the transition. The loss of output between 1989 and 1993 amounted to 25 percent resulting in decreasing consumption and rising unemployment. Real total consumption expenditure reached its pre-transition levels only in 2002 (UN ECE 2003:112–3). In spite of the considerable increase in living standards after this period as measured by the availability of various consumer goods (EBRD 2007:6), nostalgia for the previous regime has remained widespread. In 2004, 68 percent of the population agreed with the statement that life was better under communism—an increase from 63 percent in 1993 (Rose 2006:39). The disappointment in the new system could be seen in the fact that in 2006, 60 percent in Slovakia believed that there was more corruption in the new system than in the old regime (EBRD 2007:75). According to Eurobarometer (2005:21) in 2005 only 26 percent expressed satisfaction with democracy in the country, which is similar to the proportion in Hungary—a notorious laggard on reforms in the 2000s.

The widespread dissatisfaction with the system and the far-reaching reforms provides us with a puzzle: what made structural changes possible under such circumstances? In the following, first I will provide an overview of the transition process, and then will discuss the factors which helped to overcome the impediments provided by systemic distrust.

3.1 *Reforms and their aftermath*⁵

Following the Prague Spring of 1968, Czechoslovakia adhered strictly to Soviet-type communism without experimenting with reforms like Hungary. This legacy meant the need for simultaneous stabilization and liberalization at the beginning of the transition. The shock therapy was implemented by Vaclav Klaus in January 1991. Given its different industrial structure, Slovakia was particularly hard hit by these measures—between 1990 and 1992 its GDP declined by 22 percent and employment fell by 13 percent. The respective figures in the Czech Republic were 13 percent and 9 percent (UN ECE 2003:112 and 115). This lent increasing support to the vigorous opposition of Vladimír Mečiar, who argued that transition policies should be tailored to Slovakia's special conditions and cause minimal social disruption (Fisher et al. 2007:987).

Looking only at the aggregate numbers it would appear that Mečiar reached his goals. After a sharp initial downturn, the GDP started to recover as early as 1994, while inflation was reduced below 10 percent by 1996 (Morvay 2000:22). However, the favorable macroeconomic indicators hid serious microeconomic problems. Unlike in Hungary, privatization took place via voucher methods (1990–92) and domestic sales (1994–96), with the exclusion of foreign investors. The problem with the first method was that it produced diffuse ownership, and in the absence of minority shareholder protection rights it provided considerable opportunities for investment fund managers to enrich themselves (Marcincin 2000a:300–3). As they supported Mečiar's opponents, from 1994 privatization proceeded through a series of direct sales mainly to political allies, the former communist managers (Fisher et al. 2007:988). Other aspects of economic policy (state aid, favorable public contracts, state guarantees on loans, lack of bankruptcy enforcement, and creditors' right protection) complemented the political objectives of privatization and helped to preserve the inherited industrial structure (Marcincin 2000b:331–2).

The result of the above policy was a growing fiscal deficit, although hidden through creative accounting⁶ as well as a steady deterioration of international competitiveness, which was manifested in the worsening

⁵ This part relies heavily on Gyórfi (2009).

⁶ Tóth (2000:63–4) provides data from the Ministry of Finance, showing that after the initial shock of the creation of the new state, fiscal prudence was observed: after 1994 the budget deficit was never higher than 5 percent. However, he also notes the unreliability of this information and the difficulties of knowing the real

current account.⁷ The lack of international competitiveness also meant the accumulation of non-performing loans in the banking sector reaching 41 percent by 1998 (Barto 2000:365). At the same time, the soft policies that postponed restructuring were unable to protect jobs and unemployment remained steadily over 10 percent (Morvay 2000:22).

The fall of Mečiar, however, was not primarily due to the economy. The ensuing corruption, disregard of the constitution, criminal methods to deal with opponents, strong nationalist rhetoric, and mistreatment of the Hungarian minority⁸ together led to international isolation. In the economy this was shown by the lack of FDI inflows, thus making the country reliant on foreign loans to finance the twin deficit (Fisher et al. 2007:988). Even more critical was the fact that in contrast to the other Visegrád countries, Slovakia was refused first-wave accession into both the NATO and the European Union.

International rejection deeply hurt Slovak national pride and undermined Mečiar's capacity to mobilize nationalism for his survival (Bohle and Greskovits 2012:180). In 1998 the anti-Mečiar forces won the elections, which mobilized 84.4 percent of the Slovak voters. The new coalition led by Mikuláš Dzurinda included 10 political groups, which were bound together primarily by their anti-Mečiarism (Keszegh 2006:173). While the presence of former communists made radical change impossible, the prospect of EU accession held the coalition together and the government succeeded in the most urgent tasks.

The most important task was to regain the confidence of the international organizations. This was done through a very strong cooperation with the European Union during which Slovakia implemented all the necessary measures without asking for exceptions or special treatment during the negotiation process (Fisher et al. 2007:990). The international community responded well to Slovakia's efforts and in 1999 the European Commission revised its previous opinion and concluded that Slovakia fulfilled the Copenhagen political criteria. The country also joined the OECD in 2000 and the NATO in 2002.

Besides building international credibility, the government introduced an austerity package to stabilize public finances, which turned out to be in

balance (p. 65). In hindsight his analysis was correct—net lending reached -9.9 percent in 1996 and -6.3 percent in 1997 (European Commission 2012:180).

⁷ The current account deficit remained over 9 percent between 1996 and 1998 (European Commission 2012:116).

⁸ On Mečiar's anti-democratic practices, see Fish (1999).

a worse state than expected. In addition to severely restricting government expenditures, the package included a 7 percent import surcharge, which not only meant increased revenues but also contributed to reducing the current account deficit (Suster 2004:66). The government also encouraged the inflow of FDI through tax and tariff breaks as well as the privatization of banks and state monopolies. The sale of state banks after restructuring, which cost 13 percent of the GDP in 2000, resulted in a 97 percent foreign ownership of total private Slovak banking capital (*ibid.* p. 69).

While the reforms were far from popular and unemployment reached its peak at 19.8 percent in 1999, the success of the Dzurinda government in regaining international confidence helped the government in narrowly winning the elections in 2002 and forming an ideologically coherent center-right coalition without the former communists.

Freed from the tasks of European accession, from 2002 the newly elected government embarked on a series of radical reforms, which aimed to address the country's desperate employment performance via neoliberal policies. The main principles driving the reforms were to increase incentives for employment, investment and job creation (Árendás et al. 2006:229). In order to reach these objectives, systemic measures were implemented in public finance and the market regulatory framework. The main elements were the following:

- *Flat tax*: Introduction of a uniform 19 percent rate for corporate tax, personal income tax, and VAT. The idea behind this measure was to tax all income equally regardless of its source, eliminate the numerous exceptions that characterized the prior system, and simplify tax administration to reduce tax evasion (Árendás et al. 2006:230–2). Through providing tax bonus after every child, the system also aimed to motivate employment.
- *Public finance responsibility*: Increasing budgetary transparency, improving forecasting, introducing program budgeting, and developing a medium-term macroeconomic framework in order to improve the cost-effectiveness of tax-payers' money.⁹ As a result of the reforms, Slovakia now has the fourth strongest budgetary framework in the European Union (European Commission 2007:125).

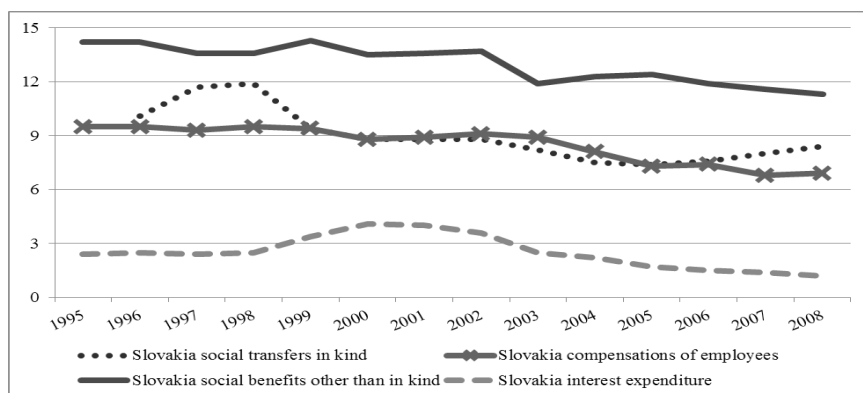
⁹ For a more detailed overview of the changes in fiscal rules see Horváth and Ódor (2009).

- *Labor market reforms*: In order to increase the flexibility of the labor market, the power of trade unions was curbed and employment protection regulations eased (Fisher et al. 2007: 982).
- *Regulatory reforms*: Easing the process of establishing and closing a business through simplified procedures and more effective registration of property.
- *Social policy reforms*: Aimed to end the situation when under certain conditions receiving aid was more beneficial to a family than gaining employment (Király et al. 2006:259–60). The length of unemployment insurance was reduced from 9 to 6 months, while the replacement ratio decreased from 60 percent of the previous wage to 50 percent. The reform of sickness benefits meant that the first 10 days of sickness was paid by the employer, which gave incentive for better monitoring. Receiving unemployment benefits was tied to actively searching for a job.
- *Pension reform*: In order to deal with the consequences of aging population, the age limit for retirement was raised to 62 years and a three-pillar pension system was introduced.
- *Health care reform*: The reform sought to transform providers into competing businesses and opened up the insurance market to private competitors. Consumers were discouraged to seek unnecessary care through the introduction of co-payment fees (Fisher et al. 2007:984).
- *Judicial reform*: Fighting corruption in the legal profession as well as implementing a new set of penalties to encourage socially functional behavior (Fisher et al. 2007:985).

The result of the reforms can be seen in the changes in expenditures. During this period Slovakia kept its deficit around 3 percent of the GDP and reduced its debt level from 50.3 percent in 2000 to 30.5 percent in 2006 (European Commission 2012:180, 184). This performance was achieved via cutting the politically most sensitive items such as social transfers and compensation of employees. The resulting decrease in debt and the credibility of the consolidation was reflected in declining interest expenditures (Figure 8.1).

The measures were also widely hailed among international observers and in 2005 Slovakia was named top reformer by the World Bank (2005). Foreign direct investment to Slovakia accelerated after the fall of the Mečiar-government—while it did not reach 2 percent of the GDP until 1998, it was steadily over 5 percent between 2000 and 2008 reaching its

Figure 8.1. Changes in selected expenditure items, 1995–2008.

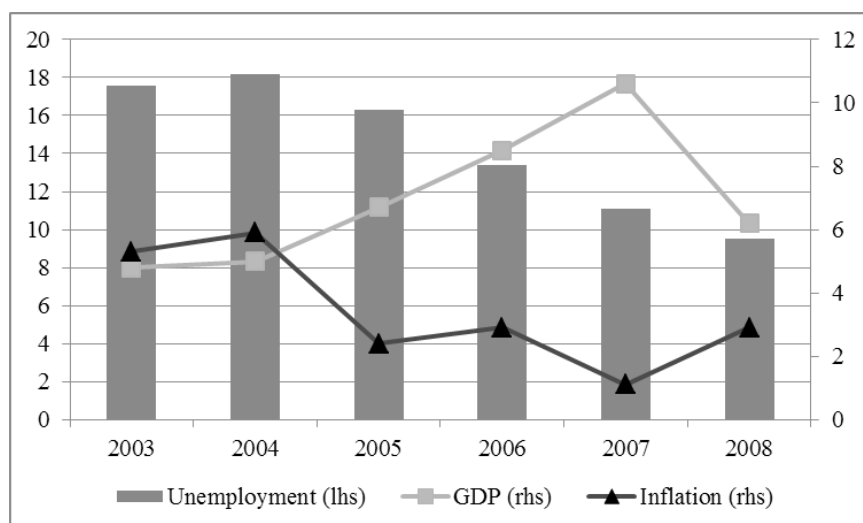


Source: European Commission (2012:156–7, 172–3, 178–9, 160–1).

Note: data are as percent of the GDP.

peak in 2002 with 16.9 percent (OECD 2013). As a result of committed policies, international confidence growth accelerated, while unemployment and inflation decreased simultaneously (Figure 8.2).

Figure 8.2. Unemployment, GDP growth, and inflation in Slovakia 2003–08 (in %).



Source: Data are taken from European Commission (2012:201).

The reforms, however, were not without costs. The low-skilled, the unemployed, and the pensioners were especially hard-hit as their benefits were reduced while the prices of food and utilities rose (Moore 2005:24–7). The food riots and violent demonstrations during 2004 in mainly Roma-populated areas in Eastern Slovakia manifested the hardship of the reforms and the unequal regional distribution of benefits. The inequality is also shown by the fact that about two-thirds of the employees earn less than the average monthly wage (EIU 2006a:14). Furthermore, while total unemployment was still high at around 10 percent, in the Eastern regions it is steadily over 20 percent (IMF 2007:14). The resulting public disaffection came to light during the 2006 elections, where an extremely low turnout (54 percent) produced a convincing majority for the left-wing anti-reform forces led by Robert Fico's Smer.

While the populist rhetoric of the new government and the return of Mečiar to government provoked speculations about the fate of Dzurinda's reforms, fears of a complete reversal proved to be unfounded. The budget submitted in December 2006 reflected the maintenance of the flat tax system as well as the commitment to EMU accession (Fisher et al. 2007:995). At the same time, in spite of the maintenance of the main elements of the reforms, a gradual softening of policies took place. Immediately after assuming power, the Fico-led government abolished the highly unpopular copayment in health care, decreased the VAT rate for foodstuff, increased state support of utility prices, as well as ruled out privatization of "strategic" enterprises including the Bratislava airport and the rail transport firm ZSSK Cargo (EIU 2006b:22–3).

The slight turnaround, however, did not undermine the reform structure built by the previous government. This was recognized in the European Commission's assessment in May 2008 that Slovakia was ready for the euro. Furthermore, the rapid growth and increasing employment made the Fico government highly popular, while Dzurinda remained one of the most unpopular public figures in Slovakia. Although the crisis brought back to power the center-right coalition in 2010 under the leadership of Ivetta Radičová, she lost a confidence vote over the participation in the European Financial Stability Fund in 2011 and the 2012 elections gave Fico's SMER-SD an absolute majority.

In spite of the regular changes in government, Slovakia continues to show strong economic performance. Implementing structural reforms during the period of international economic boom allowed the country to introduce the euro, which provided substantial protection against market forces at a time where other countries in the region struggled for keeping the value of

their currency. While given its strong export dependency, Slovakia could not avoid being hit by the crisis; nevertheless, its recovery has been among the strongest in the Eurozone. Slovak growth rate has been exceeding Eurozone average by around 2 percent since 2010 (European Commission 2012:50).

3.2 The political economy of reforms in a low-trust environment

The experiences of almost two decades in Slovakia allow some general inferences regarding the conditions under which reforms become possible even in an environment where lack of trust was likely to increase resistance to change. At first sight it appears that the *EU* was the most critical factor, which facilitated the implementation of reforms. The fall of the Mečiar regime in 1998 was largely due to the fear of being excluded from the first round of accession, while the prospect of introducing the euro was critical in maintaining financial stability following the defeat of the Dzurinda coalition in the 2006 elections. While the role of the EU in these moments certainly cannot be denied, it is important to underline that in itself it would have been insufficient for the extensive reforms in Slovakia. The rest of the region also had the perspective provided by the EU and reforms were much slower.

Similar considerations can be mentioned when looking at the role played by *crisis*. While the international isolation following Mečiar's policies was critical in facilitating the change, in itself a change of government does not bring about radical reforms. When considering the case of Slovakia, it is hard to overlook the importance of *leadership*. Dzurinda and the key officials of his government were strongly committed to market liberalism and implemented far-reaching changes on the basis of this vision. As Gould (2009:8–9) emphasizes, there was nothing inevitable about the neoliberal path. While the program was compatible with EU accession, it went far beyond of EU conditionality. Furthermore, although for the implementation of reforms the disarray of the opposition was critical (O'Dwyer and Kovalcik 2007), what kind of policies a government conducts once in power cannot be taken for granted.¹⁰ Internal commitment thus played a key role in the changes.

At the same, time, the sustainability of the reforms was critically dependent on their success. As the reforms bore fruits, investment flew

¹⁰ For example, after 2010 the center-right coalition of Viktor Orbán received a two-thirds majority, it had the chance to implement radical changes in Hungary. However, Orbán used this power in a very different manner than Dzurinda.

in and growth accelerated, there was no reason to change course. Over one third of Slovaks credited Fico's policies for the buoyant economy (Gould 2009:11). The sustainability of reforms calls attention to the importance of *administrative capacity*—without successful implementation of the right policies their sustainability cannot be ensured.

Timing also played an important role. Slovakia introduced its reforms at a time of global liquidity, and even if other countries tried to copy some of those measures following the subprime crisis, they would be unlikely to yield the same rewards. The Slovakian case shows that a set of factors together are necessary for implementing reforms in a low-trust environment. A perception of crisis opens a window of opportunity for change and then the human factor becomes critical in the quality and quantity of measures. If these reforms are successful, an elite consensus might emerge on the necessity to maintain them.

From the theoretical perspective the most important lesson of the Slovak case is the possibility to increase trust in the regime through good governance. As reforms bore fruits and economic conditions improved, trust increased as well. While in 2005 only 26 percent was satisfied with democracy, by 2007 and 2009 the proportion rose to 35 then 40 percent (Eurobarometer 2005b and c).¹¹ This means that with the increase of trust, the time-horizon of decision-making can lengthen in society, which in turn influences the time-horizon of public policies—short-term populist measures stop being the sole method to gather votes.

4 Conclusions

The chapter tried to answer two questions regarding the political economy of reforms. First, it aimed to unveil the mechanisms through which distrust hinders structural change. In the theoretical part it was argued that an environment of distrust especially towards institutions implies increased uncertainty regarding the future and a subsequent shortening of the time horizon in individual decision-making. Since vote-maximizing politicians can hardly remain impervious to the dominant time-horizon in society, a vicious circle prevails between short-sighted policies and poor perfor-

¹¹ Although this measure is not a perfect index for system support, it is widely used as a summary measure of support for political community, regime, incumbent authorities (Clarke, Dutt, and Kornberg 1993).

mance. The second question of the paper was how to overcome such a situation and the case of Slovakia was examined to answer this issue. It was found that once the window of opportunity opens, leadership is critical in implementing a set of policies, which is conducive to increase trust in the system once reforms prove successful.

The case of Slovakia indicates that although there are strong theoretical reasons to believe that implementing structural reforms in a low-trust environment is highly difficult, the presence or absence of trust creates only a tendency towards certain kinds of policies rather than acts as a determinate force. This is in line with the view of social sciences that we can discover only certain patterns rather than deterministic laws like the natural sciences.¹² At the same time, it also means that finding exceptions does not invalidate the theory and the case of Slovakia certainly should not be read as defying the relevance of trust in reforms. Instead, it underlines the enormous responsibility of policy-makers, which is even greater in a society where a long-term oriented public supports long-term oriented policy-making.

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¹² Kornai (1992:13) argues that the aim of social sciences is to discover “regularities” rather than universal, immutable laws. He argues that “any regularity is generated by a recurrent constellation of circumstances that produces behavioral patterns, decision routines by economic agents, political and economic mechanisms, and trends in economic processes that are susceptible to explanation.”

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CHAPTER 9

Europeanization with a Detour: The Case of Croatia

Fruzsina Sigér

1 Introduction

At the beginning of the 1990s, Croatia was expected to undergo a quick and successful transformation and Europeanization process and a closing-up to the old member states. Contrary to the expectations, Croatia was not eager to join the EU as soon as possible; the country missed the enlargement rounds in the 2000s. The surrounding countries (i.e., transformation countries of Central and Eastern Europe and South-eastern Europe) with a similar or even lower level of economic development had already joined the EU. Croatia is the only country in the region that could have been ready for EU-entry much sooner. Croatia seems to have gone its own way, not only in Europeanization but also in several economic policy questions. Jurčić (2011) argues that Croatia has followed an atypical model of economic policy, which has proved to be false in the light of the recent financial crisis. The question arises: was it a conscious decision to follow a “non-mainstream” way or rather the consequence of external factors? Compared to the new member states of the EU, Croatia is definitely unique regarding one aspect: the Croatian transformation and Europeanization process was interrupted by an armed conflict, which reshaped the priorities in the country. Even after it ended, the war left its mark on the social, economic, and political dimensions of Croatia, more specifically on the form of capitalism, the style of democracy, the size of state, the priorities of government finances,

the quality of public trust, and the attitude towards EU membership.¹ Needless to say, the war is not the only hindering factor of the Croatian development; it is just an additional one next to the challenging transformation process that all the other peer countries also experienced. Embedded into the transformation and Europeanization process of Croatia, this chapter aims to examine whether Croatia managed to consolidate its economy and get back to normal public finances following its armed conflict (which undoubtedly required a war budget). By answering the question, the chapter applies the theoretical framework of Europeanization and analyzes Croatia's postsocialist transformation process comparatively in two consecutive periods of time.

2 Europeanization: The theory

The theory of Europeanization tends to explore how European factors influence domestic structures. The definition of Europeanization is a rather debated issue in the international literature. The concept itself comes from the field of political science and European studies, and the majority of authors agree that Europeanization occurs when something in the domestic political or economic system is affected by "something European" (Vink 2002:1). The term "European" most usually refers to the European Union; therefore, Europeanization very often examines the influence of the European integration.

Whichever definition of Europeanization is considered, there are three conditions² that make it possible to talk about Europeanization. First, there must be a misfit or incompatibility between domestic and European institutions, policies, or processes. Second, this misfit should generate an adaptation pressure. The adaptation pressure shows up only when the misfit is perceived. The presence of a misfit can be described more or less objectively, but whether it creates an adaptation pressure depends on more subjective factors. As a general rule, the lower the compatibility between European and domestic institutions, policies, or processes, the higher the adaptation pressure. The adaptation pressure is necessary but not sufficient for changes to occur. The third condition is the existence of factors (actors or institutions) that foster a response to the adaptation pressure.

¹ For more detail on Croatian transformation, see Sigér (2010).

² Based on Börzel and Risse (2000:5), who identify two conditions.

Let us assume that the first condition of Europeanization, i.e., a misfit, is given and an adaptation pressure is generated. The third condition, the capacity that fosters a response to the adaptation pressure, varies between countries and also between policy areas. It is partly the result of the fact that institution-building and policy-making are unevenly developed across countries, and partly the result of the way these adaptation pressures are “refracted” by different domestic circumstances (Buller 2003:533). Green Cowles et al. (2001:222) argue that the greater the misfit is between domestic and European factors, the more likely does Europeanization occur. However, Knill (2001:201–2) argues that a more differentiated conception of European adaptation pressure distinguishes different levels of misfit: whether European policy demands are in contradiction with institutionally strongly embedded core patterns of the domestic structures or adjustment is possible within the given domestic context. Adaptation pressure is more likely to induce changes in cases where Europeanization requires minor or incremental changes and resistance to change is more likely when it has a revolutionary character.

Europeanization can be interpreted both as an internal and as an external impact. The internal point of view reflects on the internal process of change in the European Union and on the adaptation capacity of the member states. The process of this type of Europeanization is mutual, i.e., not only do the domestic system adapt to the European entity, but the European entity is influenced by the national systems as well, since it is constructed from the institutions and policies of its member states (Csaba 2007:141).

Concerning the third, mostly applicant countries, this self-contained approach of Europeanization is not relevant. The “outward looking” perception of Europeanization allows the conceptualization of Europeanization as an external (mostly EU-led) process, guiding applicant countries’ complex domestic economic, social, and political transformations. (Demetropoulou 2004:6). The external Europeanization process differs from the interaction between the EU and its member states: it is not mutual but is based on unilateral acceptance instead (Csaba 2007:48).

In the context of post-communist countries, two different mechanisms of Europeanization can be identified. The first mechanism is coercion, based on control and conditionality. In course of control, certain policies are inspired by positive or negative sanctions (Demetropoulou 2002:89–90). Conditionality means that specific conditions are attached to distribution of benefits. In other words, the EU’s bargaining strategy is reinforced by rewards. The presence of conditionality, however, does

not necessarily result in a successful rule transfer (Schimmelfennig and Sedelmeier 2004:670).

The second mechanism is mimicry, based on contagion and consent. Here the EU serves as a point of reference. Via the demonstration effect and interactions between international processes and domestic groups, the EU has a more indirect role and serves as a framework (Noutcheva 2003:2). In other words, through processes of persuasion and learning, the EU socializes the countries rather than coerces them. Furthermore, the countries might consider EU rules as effective benchmarks for domestic policy changes and adopt them independently of EU conditionality (Schimmelfennig and Sedelmeier 2004:670).

As for Eastern European applicants, it was the first time in enlargement history that democratic and market economy conditions were introduced even though they were implicitly in use beforehand. The newly introduced explicit conditions were inspired by the plan of “large scale” Eastern enlargement and they were designed to minimize the risk of new entrants becoming politically unstable and economically burdensome for the EU and for the old member states (Grabbe 2002:251). These two aspects of Europeanization set very general conditions. The Copenhagen criteria do not define how a market economy works or what a stable democracy looks like. Are the new member states required to establish a German economy, a British civil service, a Swedish welfare state, and a French electoral system? Here one should not forget that the EU itself does not represent a uniform model of democracy or capitalism. Moreover, neither has it made any attempt to define one common model because diversity and respect for difference is considered a key feature of EU integration (cf. Cernat 2007).

The economic aspect of Europeanization is twofold. In one aspect the economic system becomes “European.” At the very beginning of the transition this means that the economic system is restructured according to the standards of some “European” style of capitalism. A “functioning market economy” is, however, understood as a given by the EU in Agenda 2000 (1997).

The second aspect of economic integration is that the market of the candidate countries “merges” with the EU market. The second pillar of the Copenhagen criteria (establishing a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union) relate to both aspects of economic Europeanization. The second element of the economic criterion relates to market integration, as it requires the capacity to withstand competitive pressure and market

forces within the Union. The key question is whether firms in applicant countries have the necessary capacity to adapt, and whether their environment supports further adaptation to EU circumstances.

The framework for fiscal policy created by the Maastricht Treaty on the Economic and Monetary Union and the Stability and Growth Pact focuses on current member states, but it affects the accession countries as well. Among the aims of the Accession Partnerships were the establishment of an annual fiscal surveillance for the candidate countries. This grew into the Pre-Accession Economic and Fiscal Surveillance Procedure, which prepares countries for participation in the Economic and Monetary Union and its multilateral surveillance and economic policy co-ordination procedures. The Pre-Accession Economic Program (PEPs) are part of this procedure. The PEPs have two objectives. On the one hand, to outline the medium-term policy framework, including public finance objectives and structural reform priorities required for EU accession. On the other hand, PEPs offer an opportunity to develop the institutional and analytical capacity necessary to participate in the EMU (European Commission 2006). The Commission provides an evaluation of the PEPs to the Council, and the Council issues recommendations for further action after a joint meeting with the respective candidate countries. After gaining membership, conditionality continues in the form of the EMU membership goal and creates further incentives for fiscal discipline.³

Hallerberg and Yläoutinen (2008) put fiscal policy into the context of external Europeanization. Their starting point has been the usual finding that EU accession is an encouraging effect in domestic reforms, but after accession there is a general pause in reform efforts, with some countries even moving backwards. The authors have expected that fiscal policy may be different because there is an additional “carrot” after acceding to the European Union in the form of EMU membership and changes may be continued. Based on the experience of the 2004 EU enlargement, they have found that EU accession prior to 2004 did lead to some changes in budget processes, but there has been almost no change after accession. Moreover, the Stability and Growth Pact does not mean a clearly balanced fiscal position in the Eurozone either.⁴

³ See the argumentation of Dyson (2000) for EMU as Europeanization.

⁴ See Györfy (2007:93–110) on the performance and paradox of the EMU.

3 The case of Croatia

Bićanić and Franičević (2003) identified three phases of the Croatian transformation process. The first phase started with the Yugoslavian transformation in 1988. With the breaking up of Yugoslavia, Croatia stepped into the second phase of transformation. This Croatia-specific transformation plan had a very important characteristic: it had to be different from the previous one. In the 1990s Croatia was described as an authoritarian state, with reference to the post-communist regime of Franjo Tuđman. Croatia's "oscillation between ethno-nationalist sovereignist isolationism and European integration" (Jović and Lamont 2010:1614) resulted in a significant cleavage within Croatian politics until 2000, when the latter view seemed to predominate and the third phase began. In 2000 the decade-long domination of the HDZ party ended, and Croatia stepped onto an internationally accepted path of transformation. However, much of the Euroscepticism of the 1990s survived. The 2010s may be labelled as the fourth phase, in which Croatia moved beyond the post-war transition paradigm, as the dominant personalities in Croatian politics during the 1990s and early 2000s have been replaced with a new generation of post-conflict elite.

3.1 *The "nationalist" period—the Tuđman regime*

After the first multiparty elections in April 1990, the Hrvatska Demokratska Zajednica or HDZ (Croatian Democratic Union) won and Franjo Tuđman was elected as the president of Croatia. Franjo Tuđman had been a partisan and retired from the army as a major general. During the 1990s many observers noted the authoritarian tendencies of the government and the president. The authoritarian style of governance, which is accepted and even necessary in wartime, began to look more and more anachronistic and out of place in peacetime (Bartlett 2003:49–50).

The style of governance was reflected also in the country's dichromatic EU relations. Tuđman declared that Croatia was ready to accept the values that were established by the European Union and Croatia was devoted to the democratic principles on which European integration was built. However, the concept of "belonging to Europe" was not accompanied by concrete steps in Croatia; the government ignored the recommendations and conditions coming from the EU. As Jović (2006:85) argues, the integration process was delayed primarily because of Croa-

tia's self-made obstacles. These obstacles had a mainly political character; the authoritarian style of governance was unacceptable for the EU. The domestic political costs of satisfying the democratic conditionality of the EU proved to be extremely high, since applying democratic rules would have required the government to give up essential instruments on which its political power was based. All in all, the international isolation of Croatia grew in the second half of the 1990s.

At the time Croatia gained independence, its economy (and the whole Yugoslavian economy) was in the middle of recession. The Yugoslav economy experienced severe problems, since the 1970s manifested in growing external debt, accelerating inflation, stagnation, or even decreasing output and increasing unemployment. The GDP per capita in 1990 in Croatia was around the average of the Central and Eastern European (CEE) countries. However, the decline of GDP in the early 1990s was deeper in Croatia than in the CEE or Southeastern European (SEE) countries. Croatia's transformational recession (cf. Kornai 1993) was exacerbated by the breaking up of the Yugoslav market and by the Yugoslav war. In 1991, partly due to the outbreak of the war, the GDP fell by 21.1 percent and by 1994 it was reduced to two-thirds of the pre-war level. However, the magnitude of the fall in the GDP per capita ratio was in line with the CEE average. The cost of the dissolution was less severe than in the post-Soviet region.

As a result of the macro-stabilization programs, the negative growth of the GDP stopped and turned into a positive trend. The post-war reconstruction activity provided another important impetus to growth. Consumer spending and private-sector investment, both of which were postponed during the war, also contributed to the growth in 1995–97. However, the consumer boom was disrupted when the economy went into recession in mid-1998. The reason for the downturn was the 1998–99 bank crisis, during which 14 banks went bankrupt.

The war was financed mainly through inflation and in 1991 it led to an acceleration of prices (Bićanić 2001:169). Although in December 1991 the temporary Croatian currency, the Croatian dinar was introduced, the price increase continued to accelerate. Consumer prices increased by 1038 percent in 1992 and by 1249 percent in 1993.

The anti-inflationary stabilization steps announced in October 1993 proved to be very successful; retail price inflation decreased from a monthly rate of 38.7 percent to 1.4 percent in November, and was even negative (-0.5%) in December. The low inflation proved to be sustainable. The World Bank (1997:1) labelled the stabilization program as one

of the most successful in the region. In answering the question of why the program was successful, Škreb (1998:73) highlights that the initial conditions were so bad that hardly anything could have worsened it. At the same time, the program included a good mix of monetary and fiscal policy, and enjoyed strong political and popular support that made both the government and the Croatian National Bank (Hrvatska narodna banka, HNB) able to implement it. Kraft (1995:483) argues that the reason for success was rather administrative than based on market measures. The significant ownership share of the Croatian state also meant that it was possible to dictate pricing behavior to large state-owned firms and to give a strong impetus to anti-inflation policy.

Another pillar of the stabilization program was fiscal restraint. The central budget underwent important changes; the basic aim was to decrease the central budget by increasing tax revenues and limiting expenditures. Fiscal deficits were kept low, at or below 3 percent of the GDP until the end of the 1990s—huge increases in expenditures were successfully matched by increases in revenues. Despite the end of the war, during 1996–99 public expenditure rose sharply due to several factors: the significant rise in public sector wages and also public sector employment; the significant rise in healthcare and pension spending; and expenditure related to road construction. Defense expenditure remained high—the ministry of defense channeled funds to the Bosnian Croats and financed various questionable businesses (EUI 2002:22). The challenge of nationbuilding, the impact and consequences of the war, such as needs for reconstruction, and supporting refugees and displaced persons meant an upward pressure on expenditures and had a long-lasting impact on the size of the state. Total consolidated general government spending grew from 39 percent of the GDP in 1991 to 49 percent by the end of the war (World Bank 2001:4). The public administration and defense accounted for 10.7 percent of the GDP in 1998. As a consequence, the public sector became particularly large by European standards. From 1992 to 1999, public sector spending increased by more than 16 percentage points (Eurostat 2013).

Considerable efforts were made on revenue mobilization. In 1994 a new income tax and profit tax were introduced and a large number of tax exemptions were abolished, while the tax rate was broadened and marginal sales tax rates were lowered. In order to increase financial discipline, more emphasis was put on the control of tax payments (Škreb 1995:75). The government made substantial progress in aligning its tax system to international standards. The VAT was introduced at the beginning of 1998, which resulted in an increase in tax revenues equivalent to almost 4 percentage

points of the GDP in the same year. In aggregate, between 1991 and 1998 tax collection expanded by 11 percentage points of the GDP, while tax revenues as a share of the GDP reached almost 47 percent in 1998. These changes turned Croatia into one of the highest taxed economies in the region. This enormous tax burden on the private sector is likely to have increased the informal sector of the economy (World Bank 2001:4).

The government budget deficit rose from 1.4 percent of the GDP in 1994 to 8 percent of the GDP in 1999 (World Bank 2001:6). The expansion of revenues ended in late 1998, while expenditures continued to expand. The financing of the large deficits was managed by relatively easy access to international capital markets and by significant privatization revenues. As a consequence, the public sector debt increased from 28.5 percent to 38.1 percent of the GDP from 1996 to 2000 (World Bank 2001:7) and from 19 million kuna in 1994 to 46 million at the end of 1999 (HNB 2013).

In its report, the World Bank (2001:17) highlighted the growing debt burden and the exhaustion of privatization revenues and recommended a significant reduction in the size of the public sector to create space for the private sector and to achieve fiscal sustainability. Since the economy bore a relatively huge tax burden, the World Bank concluded that expenditure reduction was needed in the near and medium term to achieve these objectives.

Throughout the 1970s, Yugoslavia (similarly to other countries) had borrowed heavily from the IMF and commercial banks. However, Croatia began its individual statehood with a relatively low amount of external debt stock because the Yugoslav debt was not shared at the beginning. The volume of the debt increased slightly until 1995, but in the second half of the 1990s its yearly growth rate was about 40 percent. In March 1995 Croatia agreed with the Paris Club of creditor governments regarding the scheduling of the debt redemption and Croatia took 28.5 percent of the former Yugoslavia's previously non-allocated debt over 14 years. In July 1996 an agreement was reached with the London Club of commercial creditors as well, assuming responsibility for 29.5 percent of the former Yugoslavia's previously non-allocated debt to commercial banks. In 1997 around 60 percent of Croatia's external debt was inherited from the former Yugoslav government, either directly or due to the Paris and London Club agreement (Škreb 1998:72). With the end of the war, international markets were ready to lend again to Croatia. Both Croatian banks and corporations and the Croatian government borrowed substantial amounts during 1996–99. Concerning the external debt per GDP ratio, Croatia reached 50 percent in 1999 and exceeded the level of the peer country averages (EBRD 2000).

The size of the state was also reflected in the share of the private sector. Croatia started from a relatively favorable position regarding the share of the private sector in GDP as a consequence of the Yugoslavian type of workers' self-management and social ownership. The method of privatization contributed to the increase of state ownership because the unsold shares were transferred to state funds, although the manufacturing sector previously had not been explicitly in state hands. In 1999 the private sector share reached 60 percent of the GDP,⁵ which was significantly lower than in the CEE or SEE countries (EUI 2000:20–22).

After four years of the successful stabilization program, Franičević and Kraft (1997) warned that economic growth did not materialize because of the complex structural problems of the economy. Bičanić (2001:172) argues that the largest failures of stabilization were the lack of fiscal changes and the expanding role of the state. Croatia served as an example that price and exchange rate stability alone is not sufficient to achieve a sustainable economy and to induce growth.

3.2 *The “Europeanist” phase*

The death of President Franjo Tuđman in December 1999 and the result of the elections in 2000 meant a major change of power and brought the end of the political monopoly of the HDZ. The party lost the presidential elections as well; these were won by Stjepan Mesić, who broke with Tuđman and the HDZ in 1994. Ivica Račan became the prime minister. The new government had very different views about Croatia and its international position. The isolation was recognized as undesirable and unviable in the long run. Croatia wanted to be a “normal” country regarding Europeanization, not an exception among peer countries. The former political identity, which was based more on the opposition to “others,” seemed to be replaced by positive definitions. The ambitions of the new government were warmly welcomed in the EU and there were huge expectations towards a democratic and market-oriented turn (Bičanić and Franičević 2003:24). However, conflicts within the coalition hampered the pace of the reform process, particularly in the economy. The coalition was more of an “anti-platform” and had no well-defined agenda for change (Jović 2006:96). In October 2003 the parliament dissolved itself and the elections resulted in the defeat of the ruling coalition. The new coalition government was formed by the HDZ and two other

⁵ Other sources estimate a higher share for the private sector.

parties. Ivo Sanader was elected as the new prime minister. The international community acknowledged the return of the HDZ with anxiety, but Sanader rushed to affirm that the HDZ was a reformed, democratic center-right party, and the government's aim was to speed up the EU accession process (Jović 2006:98). The elections in November 2007 resulted in the re-election of the HDZ, and the incumbent prime minister stayed on. Ivo Sanader resigned in July 2009, which brought his deputy, Jadranka Kosor, into the head position of the government and the HDZ. The country's first female prime minister showed an aptitude for governance; she reached a revival in Croatia's stalled European Union accession process and reinforced the country's cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY). In January 2010 Ivo Josipović was elected as Croatia's third post-communist president and the first one who had not served prison time under the Yugoslav era. Under Josipović and Kosor, the transformation of Croatia stepped into an increasingly rapid pace, in which it had to cope with a range of legacies inherited from its past history of conflict and authoritarianism. Josipović and Kosor represent a new generation in Croatian politics, those who did not participate in any major way in the conflicts of the 1980–90s. That is why the 2010s may be remembered as the decade in which Croatia moved beyond the post-war transition paradigm (Jović and Lamont 2010:1609–11).

After a costly consolidation process, Croatia emerged from the recession in the final quarter of 1999 and growth picked up in 2000. Until 2003, the Croatian economic growth increased or even exceeded the average trends in SEE and CEE. It was the revival of private consumption which brought the country out of recession, reflecting partly the delayed impact of a strong real wage growth in 1999, and also the increased consumer confidence due to political changes in January 2000. However, a growth path based on domestic consumption is dangerous and unsustainable in the long run in the case of a small and open economy such as Croatia (Moore and Vamvakidis 2007:5). From 2004 onwards, the growth lost its momentum and stayed below the peer countries' average. The GDP per capita reached the level of 1990 in 2003, which indicates a slower pace of catching up than in the Visegrád countries. Considering the GDP per capita compared to the EU average, Croatia reached 50 percent of the EU27 average in 2007. The period from 2002 to 2008 and especially after 2004 was characterized by relatively low inflation. At the beginning of 2008 inflation began to rise and peaked at a rate of 5.8 percent (Eurostat 2013).

In 2000 the new government faced unparalleled expectations to place Croatia on a sustainable growth path, to achieve higher living stan-

dards, and to integrate the country into the European Union. At the same time, one of the main tasks the Račan government faced was to reduce the government budget deficit. In March 2001 the government signed a stand-by agreement with the IMF for 200 million SDR, with the aim of reducing the government deficit from 5.7 percent of the GDP in 2000 to 4.3 percent in 2002. The economic strategy for 2001–04 included fiscal adjustment, wage discipline, and continued exchange rate stability. Since the tax burden was considered already high, the fiscal adjustment could rely mainly on sustainable expenditure cuts (World Bank 2001:1). The central government deficit even increased somewhat among others due to the construction of the Zagreb–Split motorway. The delays in reducing public sector employment and in the implementation of healthcare sector reforms endangered further consolidation. In February 2003 the government signed a new stand-by agreement. Despite the failure to complete the former agreement, the IMF approved a new agreement worth 141 million USD in August 2004 (IMF 2004). Spending cuts and good revenue performance mainly due to the faster-than-projected economic growth reduced the general government deficit (Vamvakidis 2007:6) from 4.5 percent of GDP in 2003 to 1.4 percent in 2008. The financial crisis found the Croatian government unprepared; the budget was based on (as it later turned out) unrealistic real growth projections, while the foreign currency debt obligations were high (Jankov 2009:129). In November 2010 a fiscal responsibility law was adopted, aiming to reduce government spending by 1 percentage point of the projected annual GDP starting in 2012 until the primary fiscal deficit was eliminated (EBRD 2011:122).

Croatia's general government expenditures decreased to around 40 percent of the GDP⁶ by 2006 (Eurostat 2013). Based on a probably different methodology,⁷ Vamvakidis (2007:6) reported 49 percent of the GDP for general government expenditures in 2006, and described it as higher than its regional peers. Based on HNB data, Croatia showed an average public expenditure size in 2011 compared with its regional peers (HNB 2013). Government expenditures have been financed for the most part with taxes (60% of total revenue in 2008), social security contributions (35 percent) and other revenues (5 percent). The most important taxes are the VAT and excises (almost 70 percent of total tax revenue) (Mihaljek 2009:240).

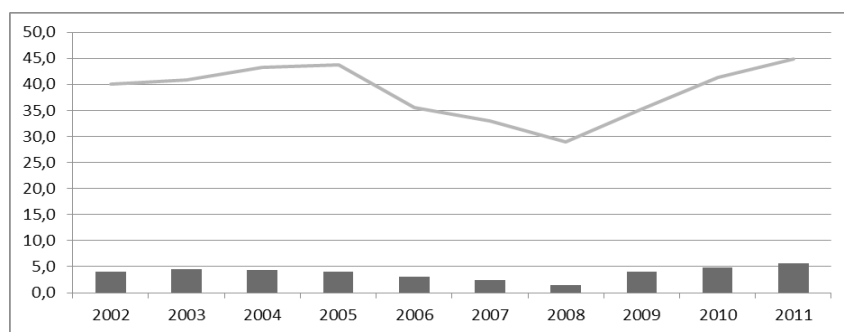
⁶ According to GFS 2001 methodology (HNB data).

⁷ Budgetary data based on the European System of Accounts (ESA 95) are available from 2004.

Public sector debt (excluding debt guaranteed by the government) declined by more than 10 percentage points of the GDP during 2002–08, due to lower borrowing needs of the central government, as pro-cyclical revenues from the domestic demand boom helped to maintain low headline deficits (Figure 9.1). However, it rose back to the 2002 level in 2010 with the onset of the financial crisis. The sharp drop in revenues increased the public sector's borrowing needs even despite efforts to restrain expenditures (IMF 2011:4–5). The recent financial recession put public finances under pressure and pushed the general government deficit up to 5.6% of the GDP in 2011 (Eurostat 2013).

The composition of public debt changed due to the government's debt management strategy, favoring domestic over external financing, and fixed-rate bonds over variable-rate syndicated loans. As a result, the share of external debt in total public debt declined from 63 percent to 43 percent from 2001 to 2010, and the share of fixed-rate bonds in total rose to 80 percent, making public debt less exposed to sudden capital outflows and interest rate changes. At the same time, dependence on the domestic market only partly reduced currency risks, as almost 60 percent of domestic public debt has been denominated in or linked to foreign currency, mainly euro (IMF 2011:6). The IMF (2012:14) described Croatian debt dynamics as unsustainable in the absence of a strong fiscal consolidation.

Figure 9.1. Government deficit and gross debt in Croatia, % of GDP



Source: Eurostat Government Statistics for 2002–09, European Commission (2012) for 2010–11.

Note: 2011 data are estimates.

The stock external indebtedness of Croatia has been rising since the beginning of the 1990s. The composition of the external debt has changed in the 2000s. Prior to 2001, foreign borrowing was driven primarily by the public sector, due to massive reconstruction needs. Since 2002 the external debt

of the private sector has started to grow, with a strong increase in foreign borrowing by domestic banks and by direct external borrowing of firms (Stamm and Macovei 2007:1–2). External debt reached 100 percent of the GDP in 2010, exacerbated with a high degree of euroization. Such high indebtedness appears as a curb on growth and stands far beyond what is prudent for an emerging market country (IMF 2011:2–3).

Franičević and Kraft (1997:686) considered four steps as important in order to speed up economic growth in 1997: (1) a high rate of domestic saving and investment; (2) a thorough restructuring, both on the level of firms and of the state itself; (3) further and consistent hardening of the soft budget constraints; and (4) full rehabilitation of the banking system. Do these obstacles still hamper the Croatian economy fifteen years later? The answer is manifold. First, both domestic saving and investment rates have improved since 1997. The domestic savings ratio rose from 11.7 percent of the GDP in 1997 to 23.4 percent in 2011 (World Bank 2013). Interestingly, domestic savings have remained relatively high and deposit rates moderate since 2009. The high level of domestic savings is one of the factors that have ensured macroeconomic stability in Croatia (IMF 2012:7). In terms of gross fixed capital formation, Croatia started from a relatively low rate compared to both CEE and SEE countries. Since 2000, capital formation rose markedly, jumping from 19 percent of the GDP in 2000 to 30 percent in 2008 (World Bank 2013). However, the high level of investments has been associated with a low growth rate. Since 2009, total and private gross fixed capital formation decreased by more than 10 percent annually, leading to a much lower contribution of capital accumulation to growth. Investment has also fallen sharply, while FDI inflows have more than halved since 2009 (IMF 2012:13).

Second, accession negotiations with Croatia were closed on 30 June 2011, which definitely means a certain level of fulfilled structural changes. The Progress Report of 2011 reported progress on implementing the planned structural reforms in areas like pension laws, unemployment benefits and non-tax fees. At the same time, fundamental structural reforms have not been achieved so far. The Economic Recovery Program, a package of fiscal measures and comprehensive structural reforms was launched in April 2010. The European Commission (2011:17) reported mixed results: progress was achieved in some of the main areas, but the measures are not enough in themselves to improve the growth potential and international competitiveness of the economy. The latest Progress Report (European Commission 2012b) stated that the implementation of the necessary structural reforms needs to be sped up. The latest

PEP was criticized by the Commission in that there was no attempt to identify obstacles of the economy directly and to assess them systematically. The program is seen as not fully and consistently establishing a clear link between strategic objectives and the various instruments and measures described. The key areas of product market reform are competition policy, state aid, privatization, railway and shipyard restructuring, energy and SME development, followed by the labor market, which suffers from deep-rooted structural problems, appearing in the form of very low participation and employment rates, as well as high rates of youth and long-term unemployment. Further reform areas are the agricultural sector, public administration, education, health care, social security, the judiciary and environmental protection (European Commission 2012a:24–26).

Third, the Croatian Competition Agency was established in early 1997, but state aid control only became one of its tasks in 2003. The first state aid act entered into force in April 2003. However, state aid kept on rising, from 2.8 percent of the GDP in 2002, to 3.4 percent in 2004 (EPC 2006). In December 2005 a new state aid law came into force which increased the competences of the Croatian Competition Agency (European Commission 2006:16–8). In 2005 the government intended to finalize plans for the restructuring of the state-owned steel companies and shipyards, in co-operation with the EU and international financial institutions, with the aim of reducing government subsidies. State aid amounted to 2.8 percent of the GDP in 2010 and estimated to be 2.6–2.8 percent of the GDP in 2011, while the EU27 average was 0.5 percent for 2011. Sector-specific aid, including agriculture and fisheries, represented 87 percent of the overall state aid in 2010, while the remainder represented horizontal aid. At the same time, Croatia has largely aligned its legislation in the field of state aid (European Commission 2012:13). With the progress of privatization, the soft budget constraint has hardened. The successful privatization of the banking sector created hard budget constraints in the financial sector. However, delay in the privatization process of the remaining state-owned companies (3.33 scores for EBRD large-scale privatization since 2003) sustains the risk of the soft budget constraint.⁸

⁸ In 2011 the EBRD reported significant changes and upgraded Croatia (from 3.00 to 3.33 scores) in the governance and enterprise reform category. The upgrading was accounted for the completion of accession negotiations with the European Union, which necessitated a commitment to restructuring key state-owned industries (EBRD 2011:16). Further enterprise restructuring is essential in order to reduce the relatively high level of state subsidies.

Fourth, the restructuring of the banking sector was carried out successfully. After the banking crisis in 1998–99, banks were consolidated and privatized, mainly by foreign investors. By 2003 the share of foreign investors in the Croatian banking sector was 90.8 percent and by 2004 the Croatian banking system reached 4.00 scores in the EBRD banking reform and interest rate liberalization category. All in all, the banking system is well developed by regional standards (EBRD 2012:107).

There are many others factors, however, which should be taken into account in the evaluation of Croatia's economic performance. Using the growth diagnosis model of Hausmann et al. (2005), Moore and Vamvakidis (2007:14–21) argue that on the one hand, main constraints of growth in Croatia are micro-level risks from the public sector. The World Bank Doing Business Report 2012 ranked Croatia at the 84th place, which means that the quality of the country's business environment has been among the least favorable among CEE and SEE countries. In the Doing Business Reports of 2007 and 2008, Croatia can be found among the Top Reformers. The progress reports of the European Commission, even the latest one, have mentioned the importance and the need of further efforts in the fight against corruption and strengthening the rule of law. According to the reports, the operation of the courts has been insufficient; a bigger effort is needed in the field of unresolved civil and commercial cases, the enforcement of judgments, and the selection and education of judges (European Commission 2012). Lack of public trust in institutions is still huge in Croatia (Budak and Rajh 2012).

On the other hand, the problem of low returns on economic activity also appears. A study from 2004 described the Croatian workforce in general as old, inflexible, inadequately educated and trained, and lacking necessary foreign language and information and communication technology skills. The performance of the labor market failed to keep step with the overall macroeconomic development (Bejaković and Lowther 2004). Unfavorable demographics and a low activity rate explain the low contribution of labor to growth before the crisis. Employment growth in Croatia has been lower than in most emerging European countries. An increase in labor force participation and improvement in labor market flexibility would help to regain competitiveness (IMF 2012:3–4).

The third constraint to growth is fiscal instability, i.e., large fiscal deficits and a high public debt level, the unsustainable debt dynamics, and the absence of strong fiscal consolidation. The public deficit represents a risk of crowding out private investment. A credible and sustainable fiscal con-

solidation would reduce vulnerabilities and lower the cost of financing and improve its availability (IMF 2012:14–5).

Following the application of Croatia in 2003, the influence of the EU on Croatian fiscal policy-making increased significantly, especially with the Pre-Accession Economic and Fiscal Surveillance Procedure. Croatia adopted its first Pre-Accession Economic Program (PEP) for 2005–07 in December 2004. The Commission evaluated the program's medium-term projections for growth, inflation, and fiscal balances rather optimistic, although coherent. The document only partially complied with the content, form, and data requested; the Commission would have preferred more detailed information on specific fiscal policy measures, their expected budgetary effects, and the potential fiscal risks involved. The structural reform agenda was considered as ambitious, with some lack of precise description of policy priorities, objectives, and key measures to be undertaken and estimated cost. In June 2005 Croatia participated for the first time in the multilateral surveillance bodies between the EU and the candidate countries (European Commission 2005:74). The second PEP was submitted in December 2005. The European Commission (2006:18) considered that it set out a generally sound medium-term macroeconomic framework and an ambitious structural reform agenda.

The PEP for 2008–10 was submitted in December 2007 and presented a coherent medium-term framework for economic policies (European Commission 2008:17). The program for 2009–11 was submitted in January 2009 and was evaluated as a sufficiently comprehensive and consistent macroeconomic and fiscal framework for economic policies (European Commission 2009:18). The PEP for 2010–12 was submitted in January 2010 and presented a sufficiently comprehensive and consistent macroeconomic and fiscal framework for economic policies. It included the “Economic Recovery Program” launched by the government in response to the continuing recession. It consisted of fiscal measures and comprehensive structural reforms for a ten-year period (European Commission 2010:17). The program for 2012–14, submitted in March 2012, was considered as a comprehensive, though optimistic macroeconomic and fiscal framework for economic policies. It included governmental plans to consolidate public finances by curbing expenditures and stimulating economic growth through infrastructure-oriented investments by publicly owned companies. The Commission stated that the budgetary process continued to show weaknesses, and the efficiency of public spending needed to be increased with the intention of medium-term fiscal sustainability (European Commission 2012:10–1).

4 Conclusion

Fiscal instability has been exacerbated by the recent crisis, but the deterioration of Croatian fiscal position, combined with a growth in the size of state, had started during the era characterized partly by the personality of Franjo Tuđman, partly due to war-time budgets. The “Europeanist” phase of Croatian transformation process inherited challenging public finances. The consolidation was both an internal need and a response to international pressure; beyond the role of the IMF it has also been anchored by Croatia’s European Union accession process. Since the adoption of the first Pre-Accession Economic Program in December 2004, the objectives of public finance and their implementation are monitored and evaluated by the European Commission. The budgetary developments since 2000 had a relatively promising period during 2002–08, considering more indices. However, this was rather due to the growing economy and strong revenues than deep institutional changes in budgetary decision-making and improvement of public trust (cf. Györffy 2007). The financial crisis hit Croatia severely. After two years of negative growth, economic output remained constant in 2011 and fell again in 2012. This development reflects both spillovers from adverse external factors and the persistence of deep structural problems. Although efforts are being made to shore up the fiscal position and reduce the government deficit, fiscal consolidation is connected to several deep reforms. Anyhow, the pressure from the EU and from other international organizations has had a strong impact on Croatian policy-making, including fiscal policy, even if at a slower pace than in the CEE countries. The characteristics of these relations did not change radically with the end of the Tuđman era; it was rather a long drawn-out progress that finally led to the signature of the accession treaty with Croatia. The EU accession negotiations and the pre-accession surveillance procedure have served as important anchors for structural reforms and fiscal consolidation in Croatia.

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The studies in *Deficit and Debt in Transition* skilfully apply insights from political economics, macroeconomics and public finance to illuminate developments in fiscal outcomes across transition economies during the run-up to the financial crisis. The book is a rich source of ideas and evidence for anyone interested in these issues, whether familiar with the region or not.

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